Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION,

Petitioner,

v.

UNITED AIR LINES, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does a federal court have the equitable authority to create substantive property interests in favor of a bankruptcy debtor and to strip a creditor of its secured status and setoff rights specifically recognized and preserved by the Bankruptcy Code, this Court's decision in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), notwithstanding?

2. What is the scope of a federal court's authority to invoke equity to justify deviation from the provisions of the Bankruptcy Code in particular cases?

PARTIES TO THE PROCEEDINGS BELOW

In addition to the parties named in the caption of this petition, HSBC Bank USA was a party in the court of appeals below. It is believed that HSBC Bank USA has no interest in the outcome of this petition.

CORPORATE DISCLOSURE STATEMENT

Petitioner U.S. Bank National Association is a national banking association and its stock is wholly owned by U.S. Bancorp. No publicly held corporation owns 10% or more of U.S. Bancorp's stock.

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U.S. Bank National Association respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-33a) is published at 438 F.3d 720. Its order denying rehearing *en banc* (App. 72a-73a) is unpublished. The opinions of the district court (App. 34a-49a) and the bankruptcy court (App. 50a- 71a) are unpublished.

STATEMENT OF JURISDICTION

The court of appeals issued its opinion on February 13, 2006, and later modified it by order dated March 28, 2006. The court of appeals denied a timely-filed petition for rehearing *en banc* on March 29, 2006. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are 11 U.S.C. § 105(a), 11 U.S.C. § 541(a), and 11 U.S.C. § 553(a), which are set forth in their entirety below.

11 U.S.C. § 105(a):

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 541(a):

> The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.
>
> (2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is—
>
> (A) under the sole, equal, or joint management and control of the debtor; or
>
> (B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.
>
> (3) Any interest in property that the trustee recovers under section 329 (b), 363 (n), 543, 550, 553, or 723 of this title.
>
> (4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510 (c) or 551 of this title.

(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as a beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

11 U.S.C. § 553(a)[1]:

> Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that—
>
> (1) the claim of such creditor against the debtor is disallowed;
>
> (2) such claim was transferred, by an entity other than the debtor, to such creditor—
>
> (A) after the commencement of the case; or
>
> (B) (i) after 90 days before the date of the filing of the petition; and (ii) while the debtor was insolvent; or
>
> (3) the debt owed to the debtor by such creditor was incurred by such creditor—
>
> (A) after 90 days before the date of the filing of the petition;
>
> (B) while the debtor was insolvent; and
>
> (C) for the purpose of obtaining a right of setoff against the debtor.

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1. Section 553 was amended by Pub. L. 109-8, which had an effective date of October 17, 2005. The text set forth above does not include the amendments because United filed its bankruptcy petition in 2002, and the amendments do not apply to cases filed before the effective date. Pub. L. 109-8 § 1501.

STATEMENT OF THE CASE

On December 9, 2002, UAL Corporation, Inc. and its subsidiaries, including United Air Lines, Inc. ("United"), filed voluntary petitions for relief pursuant to Chapter 11 of the Bankruptcy Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the Northern District of Illinois.

United is currently indebted to U.S. Bank National Association, as trustee ("U.S. Bank"), for principal amounts in excess of $30,000,000 in connection with bonds issued in 2001 to finance the construction of a cargo terminal at the Los Angeles International Airport (the "Bonds"). A portion of the proceeds from the Bonds was deposited in a construction fund (the "Construction Fund") and those proceeds were to be disbursed from time to time by U.S. Bank to United, upon the satisfaction of certain terms and conditions, for reimbursement of the cargo facility construction costs. The Bonds are secured by a security interest in favor of U.S. Bank for the benefit of the owners of the Bonds (the "Bondholders") in all of the monies held by U.S. Bank.

United commenced an adversary proceeding in its bankruptcy case[2] demanding that U.S. Bank turn over approximately $1,500,000 held in the Construction Fund, notwithstanding the fact that United remains indebted to U.S. Bank for an amount in excess of $30,000,000 and U.S. Bank has a security interest in all amounts in the Construction Fund. United's claims arose from certain draw requests United made for the reimbursement of alleged construction

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2. The bankruptcy court had subject matter jurisdiction over the adversary proceeding pursuant to 28 U.S.C. § 157(b).

expenses. One draw request for approximately $1,200,000 was submitted two business days prior to the commencement of the bankruptcy case, one substantially smaller draw request was submitted after the commencement of the case, and a third de minimus amount sought by United was never the subject of a formal draw request. U.S. Bank defended against these claims on a number of grounds, including that United was not entitled to any distribution of these funds in light of its default, U.S. Bank's setoff rights were preserved under Section 553 of the Bankruptcy Code and, finally, U.S. Bank held a valid and perfected security interest in the funds.

U.S. Bank and United filed cross-motions for summary judgment with the bankruptcy court. United did not assert in its Complaint nor argue in support of its motion or in opposition to U.S. Bank's motion that the bankruptcy court should resort to notions of equity in deciding the issues presented.

After briefing was complete and while the parties were awaiting a ruling, the bankruptcy court raised *sua sponte* the question of whether an equitable theory was relevant to (1) whether United could be "deemed" to have had an actual pre-petition property interest in specific monies in U.S. Bank's possession (as opposed to merely a cause of action against U.S. Bank on a legal, contract-based claim) with regard to the draw requests, and (2) whether U.S. Bank's perfected security interest in the Construction Fund and set-off rights recognized by Section 553 could be negated. After submission of supplemental briefs on those issues, the bankruptcy court entered summary judgment in favor of United with respect to the pre-petition draw request based on the equitable theory that the bankruptcy court had raised, and entered summary judgment in favor of U.S. Bank with respect to the much smaller post-petition draw requests. App. 50a-71a.

U.S. Bank appealed and United cross-appealed to the district court. The district court affirmed the bankruptcy court on all matters and, in the process, summarily concurred with the bankruptcy court's reasoning and analysis. App. 34a-49a.

U.S. Bank and United both appealed to the United States Court of Appeals for the Seventh Circuit. A sharply divided panel of the court of appeals issued its opinion on February 13, 2006, and later modified it by order dated March 28, 2006. App. 1a-33a. The panel majority recognized that United's claim to the funds at issue was contract-based, App. 9a, that U. S. Bank's contractual duty to pay United did not arise until after United made a request for payment, App. 17a, and that the parties' contract obligations were mutual and thus subject to setoff, App. 16a-18a. After also noting that "Section 553(a) expressly preserves creditors' setoff rights," App. 19a, the majority described the equitable theory that had been relied upon by the bankruptcy court and the district court as "a tight fit . . . [that] may appear to be reaching beyond the bounds of this case to force a result." App. 20a.

The majority then proceeded, however, to raise *sua sponte* its own new equitable theory, one that had never been previously argued by any party. Expressly in order to reach a different result than that which would have otherwise obtained under the Bankruptcy Code, the majority devised its own "equitable remedy," App. 23a, based on "the doctrine of constructive receipt," App. 21a, to deem that United had a pre-petition property interest in monies held by U.S. Bank, rather than merely a cause of action for a legal contract claim to the money, and to refuse to recognize U.S. Bank's

setoff rights or perfected security interest. App. 21a-23a. The majority explained itself, in relevant part, as follows:

> As we have demonstrated, United was entitled to the claimed funds upon making its reimbursement request—that is , on December 5, 2002. Because U.S. Bank had a non-discretionary duty to reimburse, it wrongfully withheld these funds. ***In the absence of bankruptcy***, we could simply order U.S. Bank to pay United now and the issue of damages would be resolved. ***But the bankruptcy filing***, which United is only just now overcoming, ***complicates the matter***. For if we were simply to award United its damages effective today, the money would be subject to the bankruptcy filing and would be disbursable to creditors. The purpose of damages would not be served. . . .
>
> One doctrine rooted in equity with particular analogic value here is the doctrine of constructive receipt. . . .
>
> The doctrine of constructive receipt [is] an income tax doctrine. . . .
>
> In this case, application of an equitable remedy is appropriate to ensure that the parties are made whole for the breach. . . .
>
> Accordingly, United is entitled to the full amount of the . . . [c]laims free from setoff. . . .

> We have done nothing to blur the operation of the Bankruptcy Code. Our decision today stands for the simple propositions that parties will be held to their deals and that one party may not manipulate the timing of its payments to exploit the vulnerabilities of the other. U.S. Bank's characterization of recourse to equity as some rogue remedy is baseless. Courts consistently rely on equitable remedies where damages at law are insufficient.

App. 19a-21a, 23a-24a (emphasis added).

In dissent, Judge Sykes objected that the majority had raised, *sua sponte*, a new equitable theory that was not grounded in bankruptcy law, and then had made appellate factual findings (in the context of summary judgment motions) based on speculation rather than evidence in the record, all so that it could justify changing a result that would otherwise be required by the Bankruptcy Code. Specifically, Judge Sykes wrote, in part, as follows:

> State law governs the determination of the nature and scope of the property interests that comprise the "property of the estate" in bankruptcy, *see* 11 U.S.C. § 541(a)(1), as well as the setoff rights that are preserved under § 553(a) of the Bankruptcy Code. *See Butner v. United States*, 440 U.S. 48, 54, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law"); *Strumpf*, 516 U.S. at 18, 116 S. Ct. 286 ("[Section] 553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists [under state law] is preserved in bankruptcy."). . . ." [W]hatever equitable powers

remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S. Ct. 963, 99 L. Ed. 2d 169 (1988); *see also United States v. Noland*, 517 U.S. 535, 539, 543, 116 S. Ct. 1524, 134 L. Ed. 748 (1996). "There is no general equitable override to the Bankruptcy Code." *In re Payne*, 431 F.3d 1055, 1062-63 (7th Cir. 2006) (Easterbrook, J., dissenting). . . .

That United's breach of contract damages claim is subject to setoff against its own much larger debt under the 2001 agreements does not mean the legal remedy is inadequate; resort to equity is not justified as a means of avoiding the effects of otherwise applicable law that defines the respective rights and duties of the parties. *Id.*; *see also Buntrock v. S.E.C.*, 347 F.3d 995, 997, 999 (7th Cir. 2003) ("The victim of a breach of contract could not defend his request for injunctive relief by arguing that his suit for damages would be barred by the statute of limitations."). ***Outside bankruptcy United would not be entitled to an "implied equitable transfer" merely because its breach of contract damages are legally offset by its own larger debt to U.S. Bank. The analysis should be no different inside bankruptcy***. . . .

It is undisputed that U.S. Bank received United's reimbursement request sometime on Thursday, December 5, 2002, and that United filed for bankruptcy before business opened on Monday, December 9, 2002. At most, as I have noted, two business days passed. It is also undisputed that U.S.

> Bank paid numerous prior reimbursement requests, apparently summarily and promptly, although the record does not address the course of dealing between the parties regarding the mode and timing of these payments. It is reasonable to infer that U.S. Bank was aware of United's looming bankruptcy in December 2002, for the reasons noted by the majority. But it is quite a leap from that permissible inference to a finding—by an appellate court—of manipulation or bad faith shirking of contractual obligations. Reviewing courts are not in the fact-finding business. In any event, this matter is before us on summary judgment.

App. 28a-33a (emphasis added).

The Seventh Circuit thereafter denied a timely-filed petition for rehearing *en banc* on March 29, 2006. App. 72a-73a.

REASONS FOR GRANTING THE PETITION

Under the provisions of the Bankruptcy Code, U.S. Bank was entitled to judgment in this case. To avoid that result, first the bankruptcy court and then the court of appeals majority each raised, *sua sponte*, their own non-bankruptcy equitable doctrines to justify a different outcome. Neither felt restricted, either by the Bankruptcy Code or this Court's precedent, from doing so.

While this case presents the problem in stark relief, it is not an isolated example. As will be shown, judicial reliance on "equity" to avoid results otherwise required by the Bankruptcy Code remains a systemic and pervasive problem, despite this Court's prior direction that equity cannot trump

Title 11 as enacted by Congress. This case represents a clear opportunity for this Court to address this practice and to clarify the scope of a bankruptcy court's power to justify results based on concepts of equity, a clarification that is very much needed in order to assure the equal and non-arbitrary administration of justice for debtors and creditors alike, as Congress intended.

In order fully to appreciate the unashamed nature of the majority's deviation from explicit provisions of the Bankruptcy Code and this Court's precedent, it is appropriate first briefly to review (1) the proper analysis of the issues presented under the Bankruptcy Code, and (2) this Court's prior cautions to lower courts about resorting to principles of equity to avoid outcomes otherwise dictated by the Code.

I. The Proper Result In this Case Was Dictated by the Bankruptcy Code

Assuming *arguendo* that U.S. Bank had a contractual obligation to make a payment to United prior to the bankruptcy filing, and that U.S. Bank breached that contractual obligation by failing to make the payment prior to the filing, a cause of action arose at that time in favor of United. That cause of action was a legal claim for breach of contract. Pursuant to Section 541(a) of the Bankruptcy Code, that legal claim became part of the "property of the estate" at the time of the bankruptcy filing, and any proceeds from that claim (*i.e.*, any damages eventually awarded) would also be property of the estate. 11 U.S.C. §§ 541(a)(1), (6).

At all relevant times, United was indebted to U.S. Bank, in excess of $30,000,000. Because this debt and any U.S. Bank liability to United for the unmade payment were mutual,

U. S. Bank would have a right to setoff the amount of that liability against United's debt. Such a setoff is specifically contemplated by Section 553(a) of the Bankruptcy Code, which preserves setoff rights. Moreover, even if U.S. Bank's setoff rights could be defeated, it had a perfected security interest in all of the monies in the Construction Fund. Thus, since security interests survive the filing of a bankruptcy petition, *see Farrey v. Sanderfoot*, 500 U.S. 291, 297 (1991), U.S. Bank would still have a right to the funds that was superior to any interest that United could claim in the funds.

For those straightforward reasons, U.S. Bank was entitled to judgment against United on United's claim for the unmade payment on the pre-petition draw request.

II. This Court's Relevant Precedent

In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), respondents there urged this Court that "the nature of bankruptcy proceedings – namely, their status as proceedings in 'equity'" – had allowed the court of appeals to fashion a result that was more "fair and equitable" than the result otherwise dictated by the Bankruptcy Code. *Id.* at 206. Reversing the court of appeals, the "short answer" this Court gave to those arguments was that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code," *id.*, and that a "fair and equitable" result "is one that complies with" the pertinent Code provisions. *Id.* at 207.[3]

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3. It may be noted that the dissent in the court of appeals in *Ahlers* had decried that the court of appeals' equitable decision "altered the relationship between debtor and creditor, invading

(Cont'd)

In *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996), the Court also cautioned against importing Internal Revenue Code concepts into the Bankruptcy Code: "In sum, we conclude that the 1978 Act reveals no congressional intent to reject generally the interpretive principle that characterizations in the Internal Revenue Code are not dispositive in the bankruptcy context." *Id.* at 224. It also reiterated that courts are not free to use "equity" to change results determined by the Bankruptcy Code set by Congress. *Id.* at 229 ("categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination"). *See also United States v. Nolan*, 517 U.S. 535, 539, 543 (1996).

(Cont'd)

serious policy issues properly the concern of Congress," "substituted its own findings of fact" for those disclosed by the record, and was based on an "issue [that] first appeared, suddenly and without warning, in the panel opinion." *Ahlers v. Norwest Bank Worthington*, 794 F.2d 388, 415 (8th Cir. 1986) (Gibson, J., dissenting from denial of rehearing en banc). That is sadly parallel to what happened here, as the dissent here has also pointed out:

> [R]esort to equity is not justified as a means of avoiding the effects of otherwise applicable law that defines the respective rights and duties of the parties. . . . The majority . . . locates [an equity maxim] in the domain of income tax law: the doctrine of 'constructive receipt'. . . .No one raised this doctrine, either below or on appeal. . . . [T]here is no evidence of manipulation or bad faith on the part of U. S. Bank . . . [and] [r]eviewing courts are not in the fact-finding business.

App. 31a-33a (Sykes, J., dissenting).

And just this past Term in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.*, 547 U.S. ___ (No. 05-128) (June 15, 2006), the Court reiterated that unless "Congress has included specific directions that establish the significance for bankruptcy law of a term used elsewhere in the federal statutes," courts have "no warrant to write them into the text." (Slip op. at 9) (internal quotes omitted).

In short, this Court has been clear: It is improper to rely on concepts of "equity" to justify a result other than that which the Bankruptcy Code requires.

III. The Lower Courts' Use of Equity to Change the Result

In this case, the bankruptcy court, *sua sponte*, justified changing the result dictated by the Bankruptcy Code by reference to a maxim under California law that "that which ought to be done is to be regarded as done," App. 66a, a result affirmed by the district court because it believed "that the balance of the equities favors United and not U.S. Bank," App. 48a. The court of appeals majority, not persuaded that the California state law maxim could support the result, proceeded to look instead (but also *sua sponte*) to tax law and engaged the equitable doctrine of "constructive receipt" to justify the same result. Specifically, the majority used equity first to justify a conclusion that actual "title to funds held in trust" somehow passed from U.S. Bank to United prior to bankruptcy, *see* App. 1a, and then to eliminate U.S. Bank's setoff rights under Section 553 of the Bankruptcy Code and to deny U.S. Bank's perfected secured status in those funds.[4]

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4. Although the majority did not cite the statute, the scope of a federal court's equitable power under the Bankruptcy Code is set forth in 11 U.S.C. § 105(a). Congress expressly included within that

(Cont'd)

In the process, the majority made it perfectly clear that it was resorting to equity because it was not satisfied with the result that would otherwise be dictated by the Bankruptcy Code:

> In the absence of bankruptcy, we could simply order U.S. Bank to pay United now and the issue of damages would be resolved. But the bankruptcy filing, which United is only just now overcoming, complicates the matter. For if we were simply to award United its damages effective today, the money would be subject to the bankruptcy filing and would be disbursable to creditors.

App. 19a-20a. It also made it perfectly clear that it did not think what it was doing was in any way improper, even though both U.S. Bank and the majority's own dissenting colleague, *see* App. 29a, had pointed out both what the Code required and this Court's warnings against invocations of "equity" to change that:

> U.S. Bank argues that the decision below will wreak havoc with commercial law. It believes that the bankruptcy and district courts have so blurred

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(Cont'd)

provision the same limitation this Court reiterated in *Ahlers*, that equity may only be used as an aid to carry out Code provisions, not to trump them:

> The court may issue any order, process, or judgment that is necessary or appropriate *to carry out the provisions of this title.*

11 U.S.C. § 105(a) (emphasis added).

> the lines drawn in the Bankruptcy Code as to render the Code unworkable. It argues that our affirmance would undermine well-established principles of both bankruptcy and general commercial law. . . .
>
> We have done nothing to blur the operation of the Bankruptcy Code. Our decision today stands for the simple propositions that parties will be held to their deals and that one party may not manipulate the timing of its payments to exploit the vulnerabilities of the other. U.S. Bank's characterization of recourse to equity as some rogue remedy is baseless.

App. 23a-24a.

IV. The Systemic and Pervasive Nature of the Problem

Although the conflict between the court of appeals majority and dissent in this case dramatically frames the questions presented for this Court's review, it is but the tip of the iceberg. Post-*Ahlers*, there has been dramatic disagreement throughout the case law at the circuit court, district court, and bankruptcy court levels about the extent to which courts dealing with bankruptcy issues may still employ principles of equity to justify a particular result.

Most of the case law has discussed the issue specifically in the context of Section 105(a) of the Bankruptcy Code. As noted above, section 105(a) provides, in relevant part, that "[t]he court may issue any order, process, or judgment that

is necessary or appropriate to carry out the provisions of this title." *See* note 4, *supra*.

Many circuits have continued to interpret Section 105(a) expansively, *Ahlers* notwithstanding. For example, in *In re Hornsby*, 144 F.3d 433 (6th Cir. 1998), the question presented involved the dischargeability of student loans. Section 523(a)(8) of the Bankruptcy Code provides that student loan debt is not dischargeable unless the lack of such discharge would "impose an undue hardship on the debtor and the debtor's dependents." The Sixth Circuit held that, even without a showing of "undue hardship," a bankruptcy court could grant a partial (as opposed to an "all or nothing") discharge. *Id.* at 438-39. *See also In re Saxman*, 325 F.3d 1168, 1174 (9th Cir. 2003) (allowing partial discharge of student loan debt, finding authority in congressional "intent in granting bankruptcy courts equitable authority to enforce the provisions of the Bankruptcy Code," but criticizing *Hornsby* for allowing partial discharge even if the substantive requirements of "undue hardship" were not demonstrated).

In *In re Casse*, 198 F.3d 327 (2nd Cir. 1999), the issue was whether the bankruptcy court could extend the 180-day prohibition period set forth in Section 109(g) of the Bankruptcy Code between the dismissal of an individual bankruptcy case and the permissible filing of a subsequent bankruptcy case. The Second Circuit held that, pursuant to the bankruptcy court's equitable authority under Section 105(a), it was authorized to bar *any* future Chapter 13 filing by a particular debtor, Section 109(g) notwithstanding. *Id.* at 339. In reaching that conclusion, the court noted that a circuit split existed regarding whether the bankruptcy court's equitable authority could trump the statutory dictate of

Section 109(g). *See id.* at 336 (*citing Frieouf v. United States (In re Frieouf)*, 938 F.2d 1099, 1103 (10th Cir. 1991)).[5]

Other courts, however, have held that, based on *Ahlers* and previous pronouncements from this Court, the equitable authority of the bankruptcy courts is far more limited. For example, in *In re Southmark Corp.*, 49 F.3d 1111 (5th Cir. 1995), not unlike this case, the bankruptcy court relied on principles of equity to find that a party had a property interest in certain assets based on equitable principles and a constructive trust theory. Unlike in this case, however, the Fifth Circuit held that "the bankruptcy court exceeded the limits of its equitable powers under § 105(a) by creating substantive rights that otherwise would not have existed." *Id.* at 1116. The Fifth Circuit also noted that a "claim" was distinct from a substantive property interest, a legal reality that the courts could not adjust through resort to equitable principles. *Id.* at 1117.

The list of other examples of conflicts and disparities in the case law interpreting a bankruptcy court's equitable powers is virtually endless.[6] Moreover, a review of the

5. The *Frieouf* court wrote that "the bankruptcy court's three-year prohibition against filing a bankruptcy case, which plainly contradicts the 180-day limitation under section 109(g), cannot be sustained under section 105(a)" because the "broad equitable powers that the bankruptcy courts have exercised under section 105(a) 'may not be exercised in a manner that is inconsistent with other, more specific provisions of the Code.'" 938 F.2d at 1003 n. 4 (*quoting In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601 (10th Cir. 1990)).

6. In fact, in the most recent United States Code Annotated (West 2004 and Supp. 2005), the annotations for Section 105 extend approximately 140 pages. Yet, even after that extraordinary amount of judicial effort in defining and interpreting the scope of the bankruptcy courts' equitable powers, the debate continues.

extensive scholarship on the subject confirms that a more definitive pronouncement from this Court will be necessary before anything approaching consistency can be achieved.[7]

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7. *See, e.g.*, Resnick, *The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases*, 47 B.C. L. Rev. 183, 190 (2005) ("The brevity of section 105(a) and its legislative history, however, do not provide much insight to the limits of the courts' equitable powers . . ."); Grunlock, *Note: An Appeal to Equity: Why Bankruptcy Courts Should Resort to Equitable Powers for Latitude in Their Interpretation of 'Interests' Under Section 363(f) of the Bankruptcy Code*, 47 *Wm. & Mary L. Rev.* 347, 365-66 (2005) ("Courts, scholars, and practitioners all greet the language of § 105(a) with some reservation because the breadth of power granted to bankruptcy courts by the section is not entirely clear."); Bogart, *Resisting the Expansion of Bankruptcy Court Power Under Section 105 of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall*, 35 *Ariz. St. L. J.* 793, 798 (2003) ("[T]here is variation among the decisions of the courts. Although some bankruptcy courts find it necessary or appropriate to extend section 105, others refuse to take such action in nearly identical scenarios."); Nickles and Epstein, *Another Way of Thinking about Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 *Chap. L. Rev.* 7, 9 (2000) ("Our view of section 105 as a source of supplemental law is different from the view reflected by the bankruptcy court decisions and actions. We do not believe that 105 authorizes 'supplemental law.' Indeed, we think that 105 is largely, even completely, redundant. We also think that some present uses of 105 are of questionable constitutional validity."); Krieger, *"The Bankruptcy Court is a Court of Equity": What Does that Mean?*, 50 *So. Car. L. Rev.* 275, 275-76 (1999) ("'The bankruptcy court is a court of equity.' . . . Published bankruptcy decisions of both trial and appellate courts are salted with the reference, and scholars regularly debate the scope of the bankruptcy court's equitable powers and jurisdiction. Assumed to be a truism, the

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This case squarely presents the question of whether a court may invoke equity to avoid a result otherwise required by the provisions of the Bankruptcy Code. One would have thought that question was clearly answered in the negative by this Court in *Ahlers*, but the court of appeals majority below clearly did not think so: "We have done nothing to blur the operation of the Bankruptcy Code. . . . Courts consistently rely on equitable principles. . . ." App. 23a-24a. Because the question is important and recurring, and because the court of appeals' decision conflicts with the intent of Congress as expressed in the Code, this Court should grant the petition to take up the question again.

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statement is never questioned. Used as a mantra, it is invoked to create a desired result. The question is, what does it mean?").; Meltzer, *Getting out of Jail Free: Can the Bankruptcy Plan Process be Used to Release Nondebtor Parties?*, 71 *Am. Bankr. L. J.* 1, 17-18 (1997) ("According to one school, § 105(a) is tantamount to a carte blanche grant to bankruptcy judges to take whatever action they deem necessary in a bankruptcy case to facilitate the administration of the case . . . The better view regarding the appropriate interpretation of § 105(a) is that the section should be construed far more narrowly . . .")

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DECIDED FEBRUARY 13, 2006 AND AMENDED MARCH 28, 2006

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 05-1752, 05-1814

In re UNITED AIR LINES, INC.,

Debtor.

U.S. BANK NATIONAL ASSOCIATION,

Appellant, Cross-Appellee,

v.

UNITED AIR LINES, INC.,

Debtor-Appellee, Cross-Appellant.

Argued Sept. 7, 2005.
Decided Feb. 13, 2006.
As Amended March 28, 2006.
Rehearing and Rehearing En Banc
Denied March 29, 2006.

CUDAHY, Circuit Judge.

The fundamental question in this consolidated appeal is when title to funds held in trust passes to a beneficiary. That question is broad, and an imprecise resolution might have

far-reaching implications for, among other things, the law of secured transactions. The facts of this appeal, however, limit its scope. While this appeal involves a basic question about secured-lending relationships, it more importantly involves a beneficiary on the brink of bankruptcy. How to resolve this fundamental question in this particular situation is not easy.

The cases underlying this consolidated appeal involve disputes relating to two construction bonds that the California Statewide Communities Development Authority (the Authority) established to finance a new cargo terminal at Los Angeles International Airport (LAX). That terminal was to belong to United Air Lines, Inc. (United), and as almost every air traveler knows, United entered bankruptcy in late 2002. These cases come to this Court as the consolidated appeal of two separate proceedings in the bankruptcy court. In one proceeding, HSBC Bank USA (HSBC) filed a motion seeking relief from an automatic stay so that it could distribute to bondholders approximately $4.9 million that it held as indenture trustee. In the other proceeding, United sued U.S. Bank National Association (U.S. Bank) seeking a turnover of construction funds.

The issues on appeal are whether the district court correctly affirmed (1) the bankruptcy court's grant of summary judgment to United with respect to its prepetition reimbursement for work completed prepetition; (2) the bankruptcy court's grant of summary judgment to U.S. Bank with respect to United's postpetition reimbursement request for prepetition work; and (3) the bankruptcy court's grant of HSBC's motion for relief from the automatic stay. The district court properly affirmed the bankruptcy court's dispositions and we affirm.

Appendix A

I. Background

In 1997, the Authority issued $190,240,000 in bonds on behalf of United to fund construction of an LAX cargo terminal. Chase Manhattan Bank and Trust Company, N.A. (Chase) served as indenture trustee pursuant to the agreements underlying the bonds. In 2001, the Authority issued $34,590,000 in bonds on behalf of United to provide additional funding. U.S. Bank served as indenture trustee for the agreements underlying those bonds. On December 9, 2002, United entered Chapter 11 bankruptcy.

A. The Bond Agreements

The 1997 and 2001 bond agreements share the same basic structure and are governed by California law. A trust agreement and a payment agreement underlie both bonds. The Authority first sold the bonds and deposited their proceeds into construction funds. The money in these funds is pledged for the repayment of principal and interest on the bonds and is held in trust for the bondholders. United is obligated to make these payments. The construction funds themselves, however, were designed to reimburse United for construction costs it incurred on the LAX project. Although the structure of the funds is similar, we discuss each in turn for clarity.

On November 1, 1997, the Authority entered into a trust agreement (the 1997 Trust Agreement) with Chase, which HSBC succeeded in 2003. Under the 1997 Trust Agreement, the Authority issued bonds in the aggregate sum of $190,240,000. On the same day, United and the Authority

entered into the 1997 Payment Agreement governing the bonds. This Agreement requires that United make periodic payments to HSBC to cover principal and interest due on the bonds. Unless United is in default in its payment obligations, HSBC is to pay the costs of projects upon United's written request. Any money remaining in the funds is to be used to pay bondholders after United completed the LAX cargo terminal. The bonds are secured by a pledge and assignment of the Authority's interests to HSBC, the details of which were not presented to this Court. A pledge and assignment also secure payment of the principal and interest on the bonds. HSBC holds a lien on the funds it holds, perfected by possession, to secure payment of the bonds under the 1997 Trust Agreement.

Likewise, on April 1, 2001, the Authority issued $34,590,000 in revenue bonds. The 2001 Payment Agreement requires that United make payments of principal and interest on these bonds, and the 2001 Trust Agreement requires U.S. Bank as trustee to reimburse United for construction costs upon its written request. The 2001 Trust Agreement expressly provides that U.S. Bank may rely on a written request as sufficient evidence that United incurred the costs stated, that they are properly payable out of the 2001 construction fund and that there are no liens on the money to be paid. U.S. Bank is to make payments to United "upon receipt" of a written request.

B. The U.S. Bank Requests

The reimbursement arrangement fell apart in early December of 2002—when United's bankruptcy filing appeared imminent. Prior to December 5, 2002, U.S. Bank

had summarily granted each request for construction funds without making any attempt to substantiate it. On December 5, as newspapers across the country reported that United teetered on the brink of bankruptcy, United made a draw request directing U.S. Bank to disburse $1,191,547.29 from the 2001 construction fund as reimbursement for costs incurred on the LAX project. The bankruptcy and district courts referred to these requests as Category III Claims. U.S. Bank took no action on this request, and United filed a voluntary Chapter 11 bankruptcy petition on December 9, 2002. On December 13, 2002, United submitted a request for $233,824.88 to U.S. Bank for costs it had incurred before filing its bankruptcy petition. The lower courts referred to these requests as Category II Claims. U.S. Bank again took no action. United finally incurred $30,093.51 in LAX construction costs after filing for bankruptcy. The lower courts called claims based on these costs Category I Claims. United, however, never submitted a written reimbursement request with respect to these costs. Accordingly, the bankruptcy court granted U.S. Bank's motion for summary judgment on the Category I Claims, and United does not contest that ruling here.

When United entered bankruptcy, it defaulted on its obligations under the 1997 and 2001 Trust and Payment Agreements, which expressly provide that a bankruptcy filing is a default. United, as part of its bankruptcy proceeding, also ceased paying the principal and interest on the bonds, which constitutes further default. United has not made a required payment since October 2002.

The bankruptcy court concluded that, under the terms of the 1997 and 2001 Trust and Payment Agreements, United is obliged to submit a written reimbursement request before the trustee has any payment obligation whatsoever. That court reasoned that, because submitting a proper written request is a condition precedent to obtaining reimbursement, United's claim to the Category I funds must fail. Likewise, the court concluded that the Category II Claims were subject to setoff. Since United was in bankruptcy when it filed the request, the airline was in bankruptcy when it became entitled to the funds. As such, the funds were subject to setoff under 11 U.S.C. § 553(a), which permits setoff if a creditor's claim against the estate and the estate's claim against the creditor both arose before the filing of the debtor's bankruptcy case. The bankruptcy court also concluded that § 553(a)'s mutuality requirement was satisfied because United was obliged to pay the trustee and the trustee was obliged to pay United. Because the Category II Claims fit § 553(a), the bankruptcy court reduced United's obligation to U.S. Bank by the amount United claimed.

The Category III Claims presented the most difficult question for the bankruptcy court. United argued that U.S. Bank had a nondiscretionary duty to disburse the funds for the Category III Claims upon its submission of the written request. U.S. Bank responded that it was not obliged to pay or, in the alternative, that the funds were subject to setoff since U.S. Bank was provided a reasonable time to verify the request. In the circumstance before us, a "reasonable" time carried the transaction into the United bankruptcy, occasioning a default. The bankruptcy court, however, concluded that since no agreement imposes any duty on the

trustee to confirm the validity of the submission nor extends to the trustee the discretion to do so, United's right to reimbursement arose upon its submission of the written request.

After concluding that United was entitled to the funds covered by the Category III Claims when it made the request on December 5, 2002, the bankruptcy court moved on to the very difficult issue of assessing damages. The essential problem here, the bankruptcy court explained, is that if it simply awarded damages at law to United, that money would now be subject to setoff. To avoid this problem, the bankruptcy court turned to equity. More specifically, the bankruptcy court applied the equitable maxim codified at California Civil Code § 3529, holding "[t]hat which ought to have been done is to be regarded as done, in favor of him to whom, and against him from whom, performance is due." The bankruptcy court reasoned that since U.S. Bank ought to have paid United on December 5, 2002—before United's bankruptcy filing—U.S. Bank must now pay United and that payment was to be regarded as paid on December 5. Since the court deemed the payment made before United filed for bankruptcy, it likewise concluded that the money was free from setoff.

On appeal, the district court affirmed the bankruptcy court and essentially adopted its reasoning.

C. The HSBC Matter

The situation with HSBC is slightly different, although United is in default on the HSBC bonds as well. As of December 9, 2002, Chase (HSBC's predecessor) had no

outstanding requisitions due from United. On August 13, 2003, HSBC filed a precautionary motion for relief from the automatic stay so that it could apply setoff to United's outstanding obligations and disburse the remaining money in the construction funds—about $37 million—to the bondholders. United consented to the release of all but approximately $5 million. The retained $5 million represents the amount that United contends it incurred in construction costs both before and after it filed for bankruptcy. United submitted a written reimbursement request for these costs to HSBC on September 30, 2004. The bankruptcy court entered an order allowing HSBC to offset and disburse the uncontested $32 million. HSBC voluntarily withdrew without prejudice its precautionary motion as it applied to the retained $5 million.

On February 5, 2004, HSBC filed its second motion for relief from the automatic stay. In this motion, HSBC sought the release of the retained $5 million so that it could apply setoff and disburse these funds to the bondholders. After the bankruptcy court issued its opinion in the U.S. Bank proceedings, United and HSBC agreed that the reasoning of that opinion required this motion to be granted. On October 15, 2004, United and HSBC agreed to the entry of an order granting HSBC's motion. United appealed. Since HSBC and United agreed that the bankruptcy's court's setoff reasoning in the U.S. Bank matter required that the remaining $5 million be offset as well, the district court affirmed the bankruptcy court's order granting HSBC's motion to lift the automatic stay.

Appendix A

II. Discussion

A. U.S. Bank Matter

We review a bankruptcy court's disposition of cross-motions for summary judgment de novo, with all facts and inferences viewed in a light most favorable to the respective nonmoving parties. *Hoseman v. Weinschneider*, 322 F.3d 468, 473 (7th Cir.2003). An award of summary judgment is proper when "there is no genuine issue as to any material fact and [ ] the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). U.S. Bank asserts that the bankruptcy and district courts erred in concluding that it had a nondiscretionary duty to make disbursements to United from the construction fund upon United's request. U.S. Bank further contends that even if such an obligation did exist, any obligation to perform such a duty would be contingent upon United's repayments of interest and principal. U.S. Bank also contends that regardless, the bankruptcy court erred in applying an equitable maxim codified in California law to a contractual breach, and, finally, that its perfected security interest in the construction funds survived because it maintained possession.

A critical question in this case is how the underlying agreements bind the parties to one another. While it is true, as U.S. Bank points out, that separate agreements govern, the reality is that the agreements form the basis of a single relationship: the reimbursement arrangement underlying the financing of the LAX terminal. The structure of the relationship is such that one agreement cannot be understood

in isolation from its counterpart. California law instructs that, in circumstances such as these, interrelated documents should be read together for purposes of interpretation. Cal. Civ. Code § 1642 (2005) ("Several contracts relating to the same matter, between the same parties, and made as parts of substantially the same transaction, are to be taken together."); *Versaci v. Superior Court*, 127 Cal.App.4th 805, 26 Cal.Rptr.3d 92, 97-98 (2005); *Heston v. Farmers Ins. Group*, 160 Cal.App.3d 402, 206 Cal.Rptr. 585, 594 (1984).

This discussion leads directly into the important question of duty—what duty, if any, does U.S. Bank owe to United? U.S. Bank contends that it owes United no duty because their two signatures never appeared on the same document. By the terms of the 2001 Trust Agreement, U.S. Bank reasons, the only duty it owes anyone is the fiduciary duty it owes the bondholders. Again, however, these arguments are flawed in that they misapprehend the essentially unified nature of the Trust and Bond Agreements. The parties understood from the beginning that United would receive the bond money upon its request. These contracts, then, were made for United's benefit, as well as that of the bondholders. It is well settled under California law that when a contract is made expressly for the benefit of another, that other party is a third-party beneficiary. *E.g.*, *Johnson v. Superior Court*, 80 Cal.App.4th 1050, 95 Cal.Rptr.2d 864, 873 (2000); *Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freedman*, 65 Cal.App.4th 1469, 77 Cal.Rptr.2d 479, 488-89 (1998); *Harper v. Wausau Ins. Co.*, 56 Cal.App.4th 1079, 66 Cal.Rptr.2d 64, 68 (1997); *COAC, Inc. v. Kennedy Eng'rs*, 67 Cal.App.3d 916, 136 Cal.Rptr. 890, 892 (1977). Because United is a third-party beneficiary, U.S. Bank owes United

the duty of good faith and fair dealing. *E.g.*, *Waller v. Truck Ins. Exch., Inc.*, 11 Cal.4th 1, 44 Cal.Rptr.2d 370, 900 P.2d 619, 639 (1995); *CalFarm Ins. Co. v. Krusiewicz*, 131 Cal.App.4th 273, 31 Cal.Rptr.3d 619, 628 (2005).[1]

What we have, then, are competing obligations of duty on the part of U.S. Bank; U.S. Bank owes the bondholders a fiduciary duty and United the duty of good faith and fair dealing. It is inevitable, especially in a situation such as this one, that these duties will sometimes conflict. The question then becomes how to resolve the conflicts in a manner fairest to the parties and to the terms of the agreements.

It is possible, of course, to conclude that one duty trumps the other.[2] U.S. Bank makes essentially this point, arguing that its fiduciary duty to the bondholders prevented it from paying out to a financially strapped United. But this resolution is rather arbitrary, and it is strange to contend that one's fiduciary duty to a party requires it to violate the terms of the agreement creating that fiduciary relationship.

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1. U.S. Bank's argument is curious on the point of duty. The fulcrum of its overall argument is that equity is inappropriate because this case is contractual. But on the issue of duty, U.S. Bank turns to the Restatement (Third) of Trusts to conclude that "a person who merely benefits from the performance of a trust is not a beneficiary." While that may be true, United remains a third-party beneficiary under California contract law.

2. The dissent appears to assert that the fiduciary duty must prevail under the particular circumstances here, but without citing any authority for this conclusion. The fiduciary relationship to the bondholders is the product of the same contract that creates the duty to United.

We suppose it is possible to create such an arrangement, but that certainly is not the case here. Moreover, this argument places the burden following resolution squarely on one of the parties to whom a duty is owed, which seems inappropriate. The better resolution, we think, is to balance the duties. Balancing is both more sensible and more just, and it remains truer to the agreement among all interested parties. Thus, we conclude that while U.S. Bank's fiduciary duty to the bondholders is important and must be considered, it does not erase United's claim to duty as a third-party beneficiary.

Since U.S. Bank owes United the duty of good faith and fair dealing, it must face the elephant in the room: United's bankruptcy, which was imminent in December 2002 and of which U.S. Bank rather implausibly denied anticipation at oral argument. There, U.S. Bank asserted that it had no idea United was nearing bankruptcy in December 2002. A cursory glance at the major newspapers of the day makes it hard to believe that even laypersons were unaware of the airline's impending bankruptcy. [3] Surely a major bank in a lending

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3. *E.g.*, Edmund L. Andrews, *No Help for United*, N.Y. TIMES, Dec. 8, 2002, § , at 1 ("The Bush administration refused to give United Airlines . . . a $1.8 billion loan guarantee, almost certainly pushing it to bankruptcy court."); Greg Griffin, *United Board Weighs Filing; Bankruptcy Move Could Come Today*, DENVER POST, Dec. 8, 2002, at A-1 ("United Airlines' board of directors met by teleconference Saturday afternoon to consider how to proceed with a bankruptcy filing in the next two days."); Matthew Brelis, *US Rebuffs United Airlines on $1.8B Loan Guarantees; Bankruptcy Filing Looks Likely*, BOSTON GLOBE, Dec. 5, 2002, at A1 ("United

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Airlines . . . will almost certainly be forced to file for bankruptcy protection after the federal Air Transportation Stabilization Board yesterday evening rejected its application for $1.8 billion in federal loan guarantees."); Greg Burns, *Bitter Bankruptcy Feared, Workers, Travelers Would Lose, Rivals Stand to Gain*, CHI. TRIB., Dec. 5, 2002, at 1 ("United is running out of options besides bankruptcy"); Editorial, *United: An End, and a Beginning*, CHI. TRIB., Dec. 5, 2002, at 28 ("Given the overwhelming liabilities United faces and the fact that it is burning through cash at a startling rate, the [$1.8 billion loan guarantee] decision almost certainly means the financially struggling airline will be forced to reorganize under bankruptcy protection."); Simon English, *United Airlines on Brink of Collapse*, DAILY TELEGRAPH (London), Dec. 5, 2002, at 34 ("United warned earlier this week that it was down to its last $1 billion and repeated its threat that bankruptcy looked hard to avoid, even with a loan."); *What United's Up Against*, CHI. TRIB., Dec. 4, 2002, at 6 ("But many airline analysts say bankruptcy is inevitable."); Keith L. Alexander, *Frequent Fliers Look Ahead to United Filing*, WASH. POST, at E01; James Flanigan, *United is a Poor Model for Employee Ownership*, L.A. TIMES, Dec. 4, 2002, at 3:1 ("It would be easy to look at what's happening at United Airlines, now on the brink of bankruptcy, and conclude that the concept of employee ownership in America has fallen into a tailspin."); Russell Grantham, *Delta's Status Better than United, Observers Say*, ATLANTA J.-CONST. , Dec. 4, 2002, at 1D ("United will almost certainly seek Chapter 11 protection from creditors, said [an analyst], if Machinists union members don't approve an amended $700 million concession package this week."); Greg Griffin, *United, Union Set New Vote; Airline Defers Bond Payment, Though Another Comes Due in Solvency Fight*, DENVER POST, Dec. 3, 2002, at A-01 ("Without ratification of the 7 percent pay cut by the mechanics, cash-strapped United could file for bankruptcy immediately because it will have no chance of receiving a loan guarantee from the government. . . .

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relationship with United understood the airline's dire financial situation, especially a bank that has in this case repeatedly asserted the need for due diligence.[4] This understanding implicates critically important policy questions: is it appropriate to imbue trustees with virtually unfettered discretion to disburse funds so that they can punish debtors on the verge of bankruptcy? Should we extend such

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United also is preparing for the possibility of Chapter 11, trying to line up $1.5 billion in emergency financing to fund its operations while in court, according to published reports."); John Schmeltzer, CHI. TRIB., Dec. 3, 2002, at N1 ("Hedging its bets, United also is working with private lenders to finance the company's operations should it file for court protection. 'You don't arrange bankruptcy financing unless you think you're going to file for bankruptcy,' [an analyst] said. 'If they don't file, I would be surprised.' "); *Air NZ Unfazed As United Teeters on the Edge of Bankruptcy*, N.Z. HERALD, Dec. 2, 2002 ("United is likely to file for bankruptcy within the next two weeks unless it can soon get a new wage-cut deal from reluctant mechanics and a crucial federal guarantee of a US$1.8 billion . . . loan, sources familiar with the matter said."); John Schmeltzer, *United, Mechanics Return to the Table; Flight Attendants OK Wage Cuts*, CHI. TRIB., Dec. 1, 2002, at C1 ("United doesn't have much more time before a bankruptcy filing will be its only alternative.").

4. U.S. Bank's denial is rendered all the more implausible by its assertion in its opening brief to this Court that "[w]ithholding reimbursements to United when it is expected that United will not honor its contractual obligations under the [2001] Payment Agreement was simply an action U.S. Bank deemed necessary with respect to enforcing United's obligations under the Payment Agreement." (Pet'r Br. at 15-16) (footnote omitted.) The agreements do not afford U.S. Bank this discretion.

a power even in the face of agreements that plainly create a nondiscretionary duty to disburse funds? We think not.

Our answer may have been different in a factual setting with different underlying agreements. But the reality here is that the parties negotiated agreements that afford U.S. Bank no discretion in disbursing the funds. Under California law, a trustee's duties and obligations are strictly defined by and limited to the terms of the underlying agreement, particularly in relationships involving indenture trustees. *Bryson v. Bryson*, 62 Cal.App. 170, 216 P. 391, 393 (1923). The agreements here provide that once United completes the work and once United submits a reimbursement request, U.S. Bank must pay. (2001 Payment Agreement § 3.3(a) ("Each of the payments referred to . . . shall be made upon receipt by the Trustee of a Written Request of the Corporation.").) Moreover, the Agreements exclude the need for due diligence by stating that written requests conforming to certain procedures "shall be sufficient evidence" that the items are properly reimbursable. Reading a "reasonable time to perform due diligence" clause into the agreements ignores their plain text and the course of dealing between the parties. Thus, we conclude, as did the bankruptcy and district courts, that U.S. Bank had a nondiscretionary duty to disburse funds upon an appropriate request from United.

These conclusions permit us to resolve the first step in adjudicating these claims: who is entitled to the money in absence of setoff (an issue to which we will return)? Since the terms of the agreements clearly state that once a request is properly filed, U.S. Bank must reimburse, it follows that United was entitled to the funds covered by the Category III

Claims on December 5, 2002, and the funds subject to the Category II Claims on December 13, 2002.

Under California law as preserved in the Bankruptcy Code, mutual debts arising before the commencement of a bankruptcy proceeding may be offset, subject to certain exceptions not relevant here. "The right of setoff (also called 'offset') allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the 'absurdity of making A pay B when B owes A.' " *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286, 133 L.Ed.2d 258 (1995) (quoting *Studley v. Boylston Nat'l Bank of Boston*, 229 U.S. 523, 528, 33 S.Ct. 806, 57 L.Ed. 1313 (1913)). Section 553(a) "generally permit[s] a creditor to offset, on a dollar-for-dollar basis, a debt it owes to the bankrupt party on a pre-commencement debt that the bankrupt owed to the creditor." *United States v. Maxwell*, 157 F.3d 1099, 1100 (7th Cir.1998); *see also* Cal. Civ. Pro. Code § 431.70 (2005); *Harrison v. Adams*, 20 Cal.2d 646, 128 P.2d 9, 11 (1942); *Plut v. Fireman's Fund Ins. Co.*, 85 Cal.App.4th 98, 102 Cal.Rptr.2d 36, 42 (2000).

Setoff is appropriate against the Category II Claims because, under the 2001 Agreements, United owed U.S. Bank and the bondholders repayments of principal and interest. Once United entered bankruptcy, all debts were therefore subject to setoff. United's primary defense against setoff is that the debts are not mutual. California law and § 553(a) require that, for setoff to apply, debts be between the same parties and that both arise before the filing of the bankruptcy petition. *Meyer Med. Physicians Group, Ltd. v. Health Care Serv. Corp.*, 385 F.3d 1039, 1041 (7th Cir.2004); *In re*

Doctors Hosp. of Hyde Park, Inc., 337 F.3d 951, 955 (7th Cir.2003); *Harrison*, 128 P.2d at 11-12. United argues that since, as we have concluded, U.S. Bank's obligation to pay does not arise until United submits a request, U.S. Bank's debt to United is not prepetition and therefore enjoys no mutuality with United's debt to repay principal and interest.

In order for this argument by United to succeed, we would need to read each reimbursement request as a separate act that obligates U.S. Bank. That is, we would need to conclude that U.S. Bank is bound to pay only after United submits a reimbursement request, and once that request has been paid out, U.S. Bank's obligation ceases. But that is not the arrangement here. Although United was not *entitled* to this money until it filed its request, U.S. Bank bound itself to pay, subject to request, when it entered the agreements in 2001. We have already explained that we are not willing to view the arrangement as a series of piecemeal agreements; it is improper to view the 2001 Trust Agreement and the 2001 Payment Agreement as two separate agreements because together they form a single framework of provisions governing the financing arrangement, and it not possible to understand one without reference to the other. Likewise, it is improper to treat each interaction in this arrangement as a separate transaction. Accordingly, this debt arose prepetition.

Moreover, these funds are not, as United contends, special purpose funds exempt from setoff. *See In re Ben Franklin Retail Store, Inc.*, 202 B.R. 955, 957 (Bankr.N.D. Ill.1996). This exemption applies when a debtor deposits funds for some special purpose, which are thereby held in trust for the debtor. *Id.* A typical example of a special purpose

fund is collateral pledged to satisfy obligations to third parties in the event of a draw on a letter of credit. *Id.* Here, however, the bondholders deposited the funds—not United. These funds are not earmarked in any way that imposes a special purpose on them, nor are they pledged for any third-party purpose (that is, some purpose outside the LAX project). Thus, these debts are mutual, ordinary purpose funds subject to setoff.

We next confront the issue of default. Section 6.1(c) of the 2001 Payment Agreement identifies filing a bankruptcy petition as an event of default.[5] United argues that this provision is an ipso facto default term, which 11 U.S.C. §§ 363(1), 365(e)(1), and 541(c)(1)(B) prohibit. United reasons that the default provision of the 2001 Payment Agreement provide U.S. Bank with its only avenue to setoff, which means that the default provision modifies United's interest in property. Authority supporting this proposition is slim and not quite on point. Indeed, the only case directly on point brought to our attention—an unpublished disposition at that—limits its holding to situations where debtors are not otherwise in default. *Reloeb Co. v. LTV Corp. (In re Chateaugay Corp.)*, 1993 WL 159969, at *5 (S.D.N.Y. May 10, 1993).

United, on the other hand, is in default for reasons extending beyond the bankruptcy filing; the airline has not made a required payment of principal and interest since October 2002. Even if we were to determine that the ipso facto default provisions are unenforceable, United's

5. Nothing, however, indicates that *anticipation* of bankruptcy is cause to withhold payment.

nonpayment remains a default under Section 6.1 of the 2001 Payment Agreement (which is parallel to Section 7.01 of the 2001 Trust Agreement). United contends that these nonpayments ought not count as defaults, because the Bankruptcy Code prohibits these types of payments while it remains in bankruptcy. The Code may well prohibit such payments, but the agreements—the sole authority governing this relationship—provide no basis to avoid setoff on this ground. United must be held to the deal it made, just as U.S. Bank must be held to the payment obligations it made.

In addition, United's ipso facto argument is not particularly relevant here. Section 553(a) expressly preserves creditors' setoff rights that are protected under state law. California law expressly extends setoff rights to bankruptcy filings in situations where the creditor and the debtor share a mutual debt. Thus, because the Category II Claims satisfy the requirements for setoff as outlined in California law and preserved in § 553(a), the claims are subject to setoff.

Now, having resolved the Category II Claims and explored some aspects of setoff, we can move on to the Category III Claims. As we have demonstrated, United was entitled to the claimed funds upon making its reimbursement request—that is, on December 5, 2002. Because U.S. Bank had a nondiscretionary duty to reimburse, it wrongfully withheld these funds. In the absence of bankruptcy, we could simply order U.S. Bank to pay United now and the issue of damages would be resolved. But the bankruptcy filing, which United is only just now overcoming, complicates the matter. For if we were simply to award United its damages effective today, the money would be subject to the bankruptcy filing

and would be disbursable to creditors. The purpose of damages would not be served; United would not be compensated for the damages it suffered, nor would the construction funds be available for their intended purpose. *See, e.g., Avery v. Fredericksen & Westbrook*, 67 Cal.App.2d 334, 154 P.2d 41, 42 (1944); *Mente & Co. v. Fresno Compress & Warehouse Co.*, 113 Cal.App. 325, 298 P. 126, 128 (1931). In addition, U.S. Bank would be rewarded for speculating on United's bankruptcy, which surely would increase the incidence of such behavior in the future. The question, then, is whether California law contains a remedy that will make United whole.

The bankruptcy court, as we have discussed, believed that equity provided the necessary remedy. While the maxim—that which ought to be done is deemed as having been done—is codified under California law and certainly makes sense, it may seem to be a tight fit here. First, equity is generally unavailable in breach of contract cases, although the courts are willing to turn to equity where damages at law are inadequate. *Wilkison v. Wiederkehr*, 101 Cal.App.4th 822, 124 Cal.Rptr.2d 631, 638 (2002). Second, and perhaps more fundamentally, applying the maxim in this context may appear to be reaching beyond the bounds of this case to force a result.

That appearance, however, is deceptive. The California courts, like courts of other jurisdictions, rely on a number of equitable doctrines in different situations to provide the relief required to redress a plaintiff's injuries when the law is unable to do so. *See, e.g., Cortez v. Purolator Air Filtration Prods. Co.*, 23 Cal.4th 163, 96 Cal.Rptr.2d 518, 999 P.2d 706, 716-

17 (2000); *Poultry Producers of Cent. Cal., Inc. v. Nilsson*, 197 Cal. 245, 253-55, 239 P. 1086 (Cal.1925); *Portuguese Am. Bank v. Schultz*, 49 Cal.App. 508, 193 P. 806, 807 (1920). One doctrine rooted in equity with particular analogic value here is the doctrine of constructive receipt.

The doctrine of constructive receipt—an income tax doctrine—has the same basic thrust as the equitable maxim that the bankruptcy court relied upon.[6] The constructive receipt doctrine provides that cash and receipts in kind are reportable as income either when they are actually received or when they are constructively received. Income is constructively received when, although a taxpayer has the power to receive income, she chooses not to do so—generally to obtain favorable tax treatment. *E.g.*, *Corliss v. Bowers*, 281 U.S. 376, 376-77, 50 S.Ct. 336, 74 L.Ed. 916 (1930); *Hornung v. Comm'r*, 47 T.C. 428, 433-34, 1967 WL 1012 (1967). The constructive receipt doctrine, then, addresses issues of timing, specifically to preclude taxpayers from manipulating the timing of income receipt for their own benefit. In the case before us, the problem is to preclude the lender from manipulating the timing of payment to the detriment of the borrower.

6. Despite the dissent's suggestions to the contrary, we do not directly rely on the doctrine of constructive receipt to decide this case. The doctrine only represents an apt analogy; it, like this case, directs that context and timing are relevant even in cases involving comprehensive codes. *See also In re Payne*, 431 F.3d 1055, 1057-58 (7th Cir.2005) (Posner, J.) (holding that the definition of an income tax "return" in both the Bankruptcy Code and the Internal Revenue Code depends, in part, on context). Contrary to the dissent, nothing precludes appellate courts from seeking apt analogies, whether or not suggested by the parties.

Quite clearly, then, the policy underlying the constructive receipt doctrine is appropriately responsive to the issues in this case. A key policy issue here is that a trustee should not be rewarded for speculating on the bankruptcy of a debtor. But the legal redress for such an injury is insufficient. The common thread between this case and ordinary applications of the constructive receipt doctrine is the idea that parties in a position to control disbursements may not manipulate the system to avoid the consequences of controlling requirements (e.g., the Internal Revenue Code or the Trust Agreements). U.S. Bank withheld reimbursement, predicting—accurately, it turned out—that United would enter bankruptcy. It is as improper for U.S. Bank to withhold the Category III Claims to obtain a financial advantage as it is for a taxpayer to defer the receipt of income to avoid a realization event to reduce taxes.[7] The California courts are willing to apply extralegal remedies in situations where the equities demand it. *E.g.*, *Cortez*, 96 Cal.Rptr. 2d 518, 999 P.2d at 716-17 (applying equitable considerations to a disposition under unfair competition law); *Poultry Producers of Cent. Cal., Inc.*, 197 Cal. at 255-56, 239 P. 1086 (awarding specific performance and damages for breach of contract); *see also Hirshfield v. Schwartz*, 91 Cal.App.4th 749, 110 Cal.Rptr.2d 861, 876 (2001) (" 'Equity or chancery law has its origin in the necessity for exceptions to the application of rules of

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7. U.S. Bank argues that its delay was not to procure advantage but instead to conduct due diligence. The terms of the agreements and the course of dealing expose this argument as merely a post hoc rationalization. In any event, whether or not U.S. Bank improperly withheld payment in anticipation of bankruptcy here, the dissent would provide an incentive for lenders in these circumstances to do so in the future.

law in those cases where the law, by reason of its universality, would create injustice in the affairs of men.' ") (quoting *Estate of Lankershim*, 6 Cal.2d 568, 58 P.2d 1282, 1284 (1936)). In this case, application of an equitable remedy is appropriate to ensure that the parties are made whole for the breach. And, under the particular circumstances present here, U.S. Bank's fiduciary duty to the bondholders does not, as we have earlier noted, extinguish its contractual obligation of good faith and fair dealing with respect to United. U.S. Bank may not breach its agreements in a purported effort to observe its fiduciary duty.

Finally, U.S. Bank's point about holding a perfected security interest is beside the point. As of December 5, 2002, the effective date of this transfer, United was not in bankruptcy and the lending arrangement was proceeding as planned. United was current in its payments, and U.S. Bank had no reason to invoke its security interest to withhold payment. Accordingly, United is entitled to the full amount of the Category III Claims free from setoff.

U.S. Bank argues that the decisions below will wreak havoc with commercial law. It believes that the bankruptcy and district courts have so blurred the lines drawn in the Bankruptcy Code as to render the Code unworkable. It argues that our affirmance would undermine well-established principles of both bankruptcy and general commercial law.

Those doomsday fears, however, are overstated. We have done nothing to blur the operation of the Bankruptcy Code. Our decision today stands for the simple propositions that parties will be held to their deals and that one party may not

manipulate the timing of its payments to exploit the vulnerabilities of the other. U.S. Bank's characterization of recourse to equity as some rogue remedy is baseless. Courts consistently rely on equitable remedies where damages at law are insufficient. More fundamentally, this type of remedy is appropriate and applicable in cases where one party shirks its obligations in order to obtain benefits at the expense of the other.

Moreover, if any position is likely to upend well-settled law, it is U.S. Bank's position. Despite its assertions to the contrary at oral argument, U.S. Bank conceded in briefing that it deemed it necessary to withhold payment to United because U.S. Bank believed United was nearing bankruptcy. This type of speculation is not permitted by the agreement the parties made, which once again directs that when United incurs expenses and properly requests reimbursement, U.S. Bank must pay and promptly. Sanctioning that speculation here would create incentives for future lenders to withhold funds when it appears that their borrowers are in financial trouble, regardless of their bargain.

B. HSBC Matter

The final matter before the Court is HSBC's motion for relief from the automatic stay. The relief requested would allow HSBC to distribute approximately $5 million in retained funds to bondholders. We review a bankruptcy court's decision to grant relief from an automatic stay for an abuse of discretion. *Meyer Med. Physicians Group, Ltd.*, 385 F.3d at 1041. HSBC argues that because United submitted its written reimbursement request after it filed for bankruptcy

(on September 30, 2004), those funds are subject to setoff. Accordingly, HSBC argues that the bankruptcy court properly granted its motion to lift the automatic stay and the district court properly affirmed.

HSBC and United have stipulated that their respective claims succeed or fail with the setoff issue. United submitted the reimbursement request at issue here postpetition for work it completed prepetition. United has no colorable claim that it was entitled to this money before entering bankruptcy. As we have determined that reimbursement requests submitted after bankruptcy are subject to setoff, we conclude that the HSBC motion was properly granted. Moreover, since we conclude that HSBC has setoff rights, we find it unnecessary to address HSBC's recoupment argument. Thus, we affirm the Bankruptcy Court and District Court orders granting relief from the automatic stay.

III. Conclusion

In sum, we AFFIRM the bankruptcy court and the district court in full. We direct that U.S. Bank turn over the Category III funds, which United requested on December 5, 2002. The Category II funds, which United requested on December 13, 2002, are subject to setoff. Finally, we AFFIRM the order granting HSBC's motion for relief from the automatic stay.

SYKES, Circuit Judge, concurring in part, dissenting in part.

I agree that summary judgment was properly granted to U.S. Bank on the issue of United's postpetition reimbursement request for prepetition construction expenses (the so-called "Category II" claims). Under the 2001 trust and payment agreements, U.S. Bank's obligation to pay United's construction reimbursement claims and United's obligation to pay principal and interest on the construction bonds are mutual debts subject to setoff under 11 U.S.C. § 553(a). I also agree that summary judgment was properly granted to HSBC Bank under the terms of the 1997 trust and payment agreements, as the same setoff analysis controls.

I cannot agree, however, that United's prepetition reimbursement request (the so-called "Category III" claims) should be treated differently. Neither the taxation doctrine of "constructive receipt" invoked by the majority here nor the California equitable maxim invoked by the bankruptcy court below is applicable. U.S. Bank's nonpayment of United's prepetition reimbursement request gives rise to a *legal* claim for breach of the trust and payment agreements, not an *equitable* claim for antecedent possession of money in the construction fund. As such, the claim is subject to setoff under § 553(a) because of the same mutuality in the parties' indebtedness under the 2001 agreements. *See Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286, 133 L.Ed.2d 258 (1995). Under the terms of those agreements, U.S. Bank owes United nearly $1.2 million on the Category III claims, which should be offset against the $34 million debt United owes on the underlying bonds, reducing it. But there is no

justification for treating $1.2 million of the construction fund as the property of United's bankruptcy estate, subject to turnover and not setoff. I would reverse the summary judgment in favor of United on the Category III claims.

Although the construction fund is held in trust, U.S. Bank's obligations to United are wholly contractual, not fiduciary. United is not a party to the trust agreement and U.S. Bank is not a party to the payment agreement. The California development Authority and U.S. Bank, as trustee, are parties to the trust agreement; the Authority and United are parties to the payment agreement. The majority is correct that under California law the contracts are interrelated and must be read together, but that does not mean that U.S. Bank owes any fiduciary duty to United or that equity controls the parties' substantive rights or the applicable remedies.

Under the terms of the trust agreement, U.S. Bank's fiduciary obligations as trustee are to *the bondholders only;* the proceeds of the bond issue were deposited in the construction fund, pledged to repayment of principal and interest, and "held in trust for the benefit of the bondholders." The pledge "constitute[s] a first and exclusive lien" held by U.S. Bank as trustee on the amounts in the construction fund "for the payment of the Bonds in accordance with the terms" of the trust and payment agreements.

Under the terms of the payment agreement, United agreed to pay principal and interest on the underlying bonds and the Authority agreed that proceeds in the construction fund would be made available to United "for the purpose of paying for Costs of the LAX Project." Correspondingly, the trust

agreement specifies that proceeds in the construction fund shall be made available to reimburse construction costs "upon the condition that [United] make payment" on the bonds. U.S. Bank as trustee is authorized to "take such actions as the Trustee deems necessary to enforce [United's] obligation under the Payment Agreement to make timely payment of the principal of and interest on the Bonds."

The payment agreement provides that payment of reimbursement claims "shall be made upon receipt by the Trustee of a Written Request" from United. The trust agreement provides that "[e]ach Written Request of [United] shall state, and shall be sufficient evidence to the Trustee . . . that obligations in the stated amounts have been incurred by [United] and that each item thereof is a proper charge against the Construction Fund in accordance herewith."

As between U.S. Bank and United, these terms establish only contractual—not fiduciary—rights and duties. State law governs the determination of the nature and scope of the property interests that comprise the "property of the estate" in bankruptcy, *see* 11 U.S.C. § 541(a)(1), as well as the setoff rights that are preserved under § 553(a) of the Bankruptcy Code. *See Butner v. United States*, 440 U.S. 48, 54, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law"); *Strumpf*, 516 U.S. at 18, 116 S.Ct. 286 ("[Section] 553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists [under state law] is preserved in bankruptcy."). In California (as in other states) law—not equity—provides the usual remedy for breach of contract. *Wilkison v. Wiederkehr*, 101

Cal.App.4th 822, 124 Cal.Rptr.2d 631, 638 (2002). "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988); *see also United States v. Noland*, 517 U.S. 535, 539, 543, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996). "There is no general equitable override to the Bankruptcy Code." *In re Payne*, 431 F.3d 1055, 1062-63 (7th Cir.2005) (Easterbrook, J., dissenting).

The bankruptcy court held (and the district court agreed) that United's prepetition (Category III) reimbursement claim was due and payable when U.S. Bank received a written request in the form specified by the agreements. U.S. Bank received United's $1.2 million reimbursement request on December 5, 2002—four calendar days but only two business days before United's bankruptcy filing—and it was in proper form. U.S. Bank had a contractual duty to pay United's claim "upon receipt," and its nonpayment is actionable as a breach of the trust and payment agreements. That claim is property of the bankruptcy estate. Instead of classifying it as one at law for damages for breach of contract, however, the bankruptcy court invoked an equity maxim codified at *section 3529* of the California Civil Code—"[t]hat which ought to have been done is to be regarded as done"—and treated the funds as having been transferred to United prior to the bankruptcy filing. The court further held (on the strength of this equitable maxim) that this "implied" transfer had the effect of terminating U.S. Bank's security interest because a security interest in money is perfected by possession and under California law continues only while the secured party

retains possession. *See* CAL. COM. CODE § 9313(d). Thus, the court concluded, U.S. Bank was holding property that belonged free and clear to United's bankruptcy estate, and $1.2 million of the construction fund was subject to turnover and not setoff.

This approach was unwarranted. It ignores the fact that the construction fund is held in trust for the benefit of the bondholders, not United. Equity should not be invoked to enlarge United's contractual rights at the expense of the bondholders' fiduciary interests. It also conflicts with California law, under which the nonpayment of the reimbursement claim is actionable as a legal claim for breach of contract, foreclosing application of equitable remedies. " 'Equity follows the law and, when the law determines the rights of the respective parties, a court of equity is without power to decree relief which the law denies.' " *Wilkison*, 124 Cal.Rptr.2d at 638 (quoting *Shive v. Barrow*, 88 Cal.App.2d 838, 843-44, 199 P.2d 693 (1948) (citing *Morrison v. Land*, 169 Cal. 580, 586, 147 P. 259 (1915))). When the remedy at law is adequate, equity will not step in to rescue a claimant from other circumstances—particularly circumstances of his own making. *See, e.g.*, *Wilkison*, 124 Cal.Rptr.2d at 640-41 ("[I]f the plaintiff's cause of action is one for which the legal remedy of damages is generally deemed adequate, it does not become inadequate and justify a decree of specific performance merely because the legal remedy has been lost through neglect." (quoting 5 B.E. WITKIN, CAL. PROCEDURE, Pleading, § 759, at 215 (4th ed.1997))).

That United's breach of contract damages claim is subject to setoff against its own much larger debt under the 2001

agreements does not mean the legal remedy is inadequate; resort to equity is not justified as a means of avoiding the effects of otherwise applicable law that defines the respective rights and duties of the parties. *Id.*; *see also Buntrock v. S.E.C.*, 347 F.3d 995, 997, 999 (7th Cir.2003) ("The victim of a breach of contract could not defend his request for injunctive relief by arguing that his suit for damages would be barred by the statute of limitations."). Outside bankruptcy United would not be entitled to an "implied equitable transfer" merely because its breach of contract damages are legally offset by its own larger debt to U.S. Bank. The analysis should be no different inside bankruptcy.

The majority apparently views the bankruptcy court's use of the California equity maxim with skepticism but strains to find another that will produce the same result. It locates one in the domain of income tax law: the doctrine of "constructive receipt," whereby income is deemed received and reportable to the Internal Revenue Service when it is actually *or* constructively received, the latter occurring when the taxpayer has the power to receive income but chooses not to, usually for tax avoidance purposes. No one raised this doctrine, either below or on appeal. We should generally refrain from deciding nonjurisdictional issues on grounds not asserted by the parties, *see United States v. Nash*, 29 F.3d 1195, 1202, n. 5 (7th Cir.1994), not least because it sabotages the adversarial process. *See McNeil v. Wisconsin*, 501 U.S. 171, 181 n. 2, 111 S.Ct. 2204, 115 L.Ed.2d 158 (1991) ("What makes a system adversarial rather than inquisitorial is . . . the presence of a judge who does not (as an inquisitor does) conduct the factual and legal investigation himself, but instead decides on the basis of facts and arguments pro

and con adduced by the parties."). Parties in court have the right to address the arguments made by their opponents and rely on the doctrine of waiver for arguments not made. Moreover, decisional grounds invoked sua sponte by an appellate court may lack appropriate factual support and have not been subjected to normal adversarial testing, which could expose weaknesses, or worse, outright error.

The majority believes the doctrine of constructive receipt "is appropriately responsive to the issues in this case" because it "addresses issues of timing, specifically to preclude taxpayers from manipulating the timing of income receipt for their own benefit." As applied here, according to the majority, the doctrine serves to prevent U.S. Bank from "speculating" on United's bankruptcy by manipulating the timing of its payment on the reimbursement claim. The majority also justifies application of the doctrine as a means of enforcing U.S. Bank's contractual duty of good faith and fair dealing. But there is no evidence of manipulation or bad faith on the part of U.S. Bank and no authority for the importation of this income tax doctrine into a breach of contract dispute.

It is undisputed that U.S. Bank received United's reimbursement request sometime on Thursday, December 5, 2002, and that United filed for bankruptcy before business opened on Monday, December 9, 2002. At most, as I have noted, two business days passed. It is also undisputed that U.S. Bank paid numerous prior reimbursement requests, apparently summarily and promptly, although the record does not address the course of dealing between the parties regarding the mode and timing of these payments. It is

reasonable to infer that U.S. Bank was aware of United's looming bankruptcy in December 2002, for the reasons noted by the majority. But it is quite a leap from that permissible inference to a finding—by an appellate court—of manipulation or bad faith shirking of contractual obligations. Reviewing courts are not in the fact-finding business. In any event, this matter is before us on summary judgment.

Application of the taxation doctrine of constructive receipt is no more supportable than application of the California equity doctrine invoked by the lower courts. Accordingly, I would reverse the summary judgment in favor of United on the issue of the Category III claims and to that extent must respectfully dissent.

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED FEBRUARY 24, 2005

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Case Nos. 04 C 6643
04 C 6644
04 C 6885

Honorable John W. Darrah

U.S. BANK NATIONAL ASSOCIATION,

Appellant and Cross-Appellee,

v.

UNITED AIR LINES, INC.,

Appellee and Cross-Appellant.

UNITED AIR LINES, INC.,

Appellant,

v.

HSBC BANK USA NATIONAL ASSOCIATION, as trustee,

Appellee.

Appendix B

MEMORANDUM OPINION AND ORDER

This matter comes before the Court on the appeal and cross-appeal of the judgment of the bankruptcy court of September 29, 2004, by U.S. Bank National Association ("US Bank") and United Airlines, Inc. The appeal of the judgment of the bankruptcy court of October 15, 2004, by United, of a related case, is also before the Court. For the reasons that follow, the decision of the bankruptcy court as to the September 29, 2004 order is affirmed; and the decision of the bankruptcy court as to the October 15, 2004 order is affirmed.

BACKGROUND

On or about November 1, 1997, the California Statewide Communities Development Authority ("CSCDA") entered into a trust agreement (the "1997 Trust Agreement") with Chase Manhattan Bank and Trust Company. Pursuant to the 1997 Trust Agreement, the CSCDA issued bonds in an aggregate amount of $190,240,000. The bonds were issued to finance the construction, modification, and expansion of certain buildings and improvements at Los Angeles International Airport ("LAX"). HSBC Bank USA National Association ("HSBC") succeeded to Chase Manhattan's interest under the 1997 Trust Agreement or about January 27, 2003.

Also on or about November 1, 1997, United and the CSCDA entered into a payment agreement (the "1997 Payment Agreement") relating to the bonds. Under the 1997 Payment Agreement, United agreed to make periodic payments to HSBC to cover principal and interest due on the bonds. In particular, United is obligated to pay to HSBC, on or before each date on which principal or interest comes

due, "a sum equal to the amount then payable as principal . . . and interest upon the Bonds as provided in the Trust Agreement."

The 1997 Trust Agreement establishes a construction fund to be held by HSBC in trust (the "1997 Construction Fund"). A majority of the proceeds from the sale of the bonds was deposited into the 1997 Construction Fund pursuant to the 1997 Trust Agreement. Absent a default under the terms of the 1997 Payment Agreement, monies in the 1997 Construction Fund were to be applied to pay the costs of the projects pursuant to a written requisition submitted by United to HSBC. Upon completion of all the projects, all remaining monies in the 1997 Construction Fund were to be used to pay the bondholders.

The bonds are additionally secured by a pledge and assignment to HSBC of certain CSCDA's interests, which pledge and assignment secures payment of principal and interest on the bonds. HSBC further has a perfected lien on funds held by it, including the 1997 Construction Fund, to secure payment of the bonds in accordance with the terms of the 1997 Trust Agreement.

On or about April 1, 2001, the CSCDA issued, on behalf of United, $34,590,000 in California Statewide Communities Development Authority Special Facilities Revenue Bonds, Series 2001 (the "2001 Bonds"). The proceeds of the bonds were made available to United pursuant to a Payment Agreement dated April 1, 2001, between United and CSCDA (the "2001 Payment Agreement") and a trust agreement dated April 1, 2001, between CSCDA and the trustee, US Bank (the "2001 Trust Agreement"). A portion of the proceeds of

the 2001 Bonds were deposited into, among other accounts, a construction fund (the "2001 Construction Fund") established with US Bank as trustee pursuant to the 2001 Trust Agreement.

All of the monies in the 2001 Construction Fund are pledged to the repayment of principal and interest on the 2001 Bonds and are held in trust for the benefit of the bondholders. The 2001 Construction Fund was designed to reimburse United for its costs in constructing certain projects at LAX. United, in turn, is obligated under the 2001 Payment Agreement to make payments of principal and interest on the 2001 Bonds.

In order for United to obtain disbursements from the 2001 Construction Fund, United must submit to US Bank a "Written Request of Corporation." Section 3.04 of the 2001 Trust Agreement sets out the information that must be provided and the representations that must be made in a Written Request. Section 3.04 also provides, in pertinent part, that "[b]efore any payment is made from the Construction Fund by the Trustee, the Corporation [United] *shall cause to be filed* with the Trustee a Written Request for the Corporation." (Emphasis added). Similarly, Section 4.1 of the 2001 Trust Agreement states, in pertinent part, that "[t]he Corporation shall submit a Written Request of Corporation for disbursements from Construction Fund in accordance with § 3.04 of the Trust Agreement." The 2001 Trust Agreement expressly provides that US Bank may rely on a Written Request that fulfills the requirements of Section 3.04 as "sufficient evidence" that the costs stated were incurred and are properly paid out of the 2001 Construction Fund and

that there are no liens on the monies to be paid. Payment to United is to be made "upon receipt" of a Written Request.

From and after April 1, 2001, United submitted to US Bank, and US Bank honored, numerous Written Requests for disbursements from the 2001 Construction fund as reimbursement for costs properly incurred by United with respect to LAX construction projects. Before December 5, 2002, US Bank had summarily granted each of these requests without making any attempt to substantiate the information contained therein.

On December 5, 2002, in accordance with Section 3.04 of the 2001 Trust Agreement, United submitted Requisition No. 11 (the "December 5 Draw Request") to US Bank, directing US Bank to disburse $1,191,547.29 in funds from the 2001 Construction Fund as reimbursement for costs incurred by United with respect to LAX projects. All of the costs associated with this request were incurred prior to December 5, 2002. US Bank did not honor the request or release the funds.

On December 9, 2002, United filed a voluntary petition under Chapter 11 of Title 11, United States Code.

On December 13, 2002, in accordance with Section 3.04 of the 2001 Trust Agreement, United submitted Requisition No. 12 (the "December 13 Draw Request") to US Bank, directing US Bank to disburse $233,824.48 in funds from the 2001 Construction Fund for costs incurred by United in respect to LAX projects. US Bank did not honor the request or release the funds.

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In addition to the amounts contained in the December 5 Draw Request and the December 13 Draw Request, United has incurred an additional $30,093.51 towards the cost of LAX projects.

On August 13, 2003, HSBC filed its Precautionary Motion for Relief From the Automatic Stay, to the Extent Necessary, to Effectuate Setoff Rights and to Apply and Disburse Monies in a Certain Construction Fund (Los Angeles International Airport Bond, Series 1997) (the "original Construction Fund Lift Stay Motion"), wherein HSBC sought relief from the automatic stay, to the extent necessary, to apply and disburse to bondholders approximately $37 million in funds on deposit in the Construction Fund. United consented to the relief sought in the Original Construction Fund Lift Stay Motion, except to the extent the Original Construction Fund Lift Stay Motion sought authorization to apply and disburse $4,891,660 of the 1997 Construction Fund (the "Retained Monies"), which monies United asked to be released. The difference between the Retained Monies (as to which United did not consent to relief from the automatic stay) and the balance of the 1997 Construction Fund (as to which United did consent to relief from the automatic stay) is that the Retained Monies represent the amount United claims it had incurred in construction costs, both before and after the petition date, but for which it had not sought to be nor had been reimbursed because it had never submitted a requisition to the trustee prepetition.[1] HSBC voluntarily withdrew the Original Construction Fund Lift Stay Motion solely as it applied to the Retained Monies, without prejudice to refile.

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1. On September 30, 2004, United submitted a Requisition for the Retained Monies.

Appendix B

On December 16, 2003, United filed an adversary proceeding against US Bank (the "US Bank Litigation") seeking a turnover of certain amounts on deposit in the 2001 Construction Fund. United's complaint set forth claims for the turnover of three different sets of construction funds. First, United sought a turnover of funds to reimburse costs for which United had never submitted a written request (the "Category I Claims"). Second, United sought a turnover of funds from the December 13 Draw Request. These funds related to costs incurred prepetition but for which a draw request was only submitted postpetition (the "Category II Claims"). United's third turnover claim was for funds for the December 13 Draw Request. United had submitted this draw request to US Bank prior to filing bankruptcy and prior to any other default for prepetition expenditures (the "Category III Claims").

Both United and US Bank filed motions for summary judgment. US Bank argued, *inter alia*, that United was not entitled to the turnovers because US Bank had a right to setoff pursuant to Bankruptcy Code Section 553. HSBC filed a supporting brief making the same argument.

On September 20, 2004, the bankruptcy court granted in part and denied part both parties' motions for summary judgment. The bankruptcy court addressed each category of United's turnover claims separately. With respect to the Category I Claims, the bankruptcy court found that because a Written Request was required under the agreement, such a request was a condition precedent to the requirement that US Bank turnover monies from the 2001 Construction Fund. Because United had not complied with the requirement of

submitting a Written Request, the bankruptcy court denied United's turnover request as to these funds.

As to the Category II Claims, the bankruptcy court found that the Category II Claims were subject to US Bank's setoff rights pursuant to Section 553 in that there was mutuality of parties; and both United's claims against US Bank (related to and for payment of construction costs from the 2001 Construction Fund) and US Bank's claim lint United (for amounts due on the US Bank bonds) arose pre-petition.

The Category III claims were evidenced by a Written Request submitted by United prior to the petition date. The bankruptcy court found that in the absence of default, and pursuant to the parties' agreement, US Bank had an obligation to turnover the funds to United as soon as a request was made. Therefore, relying on the maxim of equity codified in the California Code, "that which ought to have been done is to be regarded as done, in favor of him to whom, and against him from whom, performance is due," the bankruptcy court held that once United filed the request, that portion of the 2001 Construction Fund represented by the Category III Claims became property of United; and turnover was appropriate.

On February 5, 2004, after the initiation of the US Bank Litigation, but prior to its resolution, HSBC filed its Motion for Relief from the Automatic Stay, to the Extent Necessary, to Effectuate Setoff Rights and Apply and Disburse Retained Monies in a Certain Construction Fund (Los Angeles International Airport Bond, Series 1997) (the "Retained Monies Lift Stay Motion"). In the retained Monies Lift Stay

Motion, HSBC sought relief from the automatic stay to apply and disburse to bondholders, as provided in the 1997 Trust Agreement, the Retained Monies.

United and HSBC agreed that because the Retained Monies were analogous to the funds that were the subject of the Category I Claims in the US Bank Litigation, insofar as United had not sought reimbursement thereof through requisitions prior to the petition date, the 2001 Construction Fund Opinion was dispositive of the issues raised in the Retained Monies Lift Stay Motion and required the granting of that motion. Therefore, on October 15, 2004, United and HSBC agreed to the entry of an Agreed Order that granted the Retained Monies Lift Stay Motion "for the reasons stated in the US Bank Construction Fund Order."

LEGAL STANDARD

A bankruptcy court's grant of summary judgment is reviewed *de novo*. *Hoseman v. Weinschneider*, 322 F.3d 468, 473 (7th Cir. 2003) (*Hoseman*). All of the facts and the inferences drawn therefrom are viewed in the light most favorable to the nonmoving party. *Hoseman*, 322 F.3d at 473. Similarly, a bankruptcy court's interpretation of statute is a question of law reviewed *de novo*. *See Meyer v. Rigolon*, 30 F.3d 1375, 1378 (7th Cir. 1994). The Court reviews the bankruptcy court's factual findings for clear error. *Hoseman*, 322 F.3d at 473.

Summary judgment is proper if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, show that there is no

genuine issue as to any material fact." Fed. R. Civ. P. 56(c); *see also Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23 (1986). All the evidence and the reasonable inferences that may be drawn from the evidence are viewed in the light most favorable to the nonmovant. *Miller v. American Family Mut. Ins. Co.*, 203 F.3d 997, 1003 (7th Cir. 2000). Summary judgment may be granted when no verdict could reasonably be returned for the nonmoving party. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986).

DISCUSSION

US Bank appeals the September 29, 2004 order of the bankruptcy court, arguing that the bankruptcy court erred in granting summary judgment in United's favor as to the Category III Claims. United appeals the September 29, 2004 order of the bankruptcy court, arguing that the bankruptcy court erred in granting summary judgment in US Bank's favor as to the Category II Claims and Category I Claims. United appeals the October 15, 2004 order of the bankruptcy court, making the same arguments it makes in regards to the bankruptcy court's September 29, 2004 order as to the Category I and II Claims.

The Category I Claims

The Category I Claims consist of funds for which United seeks reimbursement and for which United had never submitted a Written Request. The bankruptcy court held that the submission of a Written Request was a condition precedent to the requirement that US Bank turnover monies from the 2001 Construction Fund. Because United had not

complied with the requirement of submitting the Written Request, United's request for a turnover was denied. Similarly, United had not submitted a requisition for the monies held by HSBC in the 1997 Construction Fund.

United argues that the bankruptcy court erred in finding that the submission of the Written Request was a condition precedent to obtaining payment from the 2001 Construction Fund. As in the bankruptcy court, United argues that the Written Request was ministerial because United immediately obtained a property interest in the 2001 Construction Fund upon incurring construction costs.

The 2001 Trust and Payment Agreements do not support United's argument. As indicated above, United must submit a Written Request before US Bank has a payment obligation of any kind. In light of the provisions, a Written Request was a substantive condition precedent to United's obtaining disbursements from the 2001 Construction Fund. Because United failed to submit the Written Request with respect to the post-petition costs, US Bank has no obligation to pay United on its claim.

The Category II Claims

The Category II Claims consist of funds for which United seeks reimbursement and for which United had incurred prepetition but for which a Written Request was not submitted until after United filed bankruptcy. The bankruptcy court held that the funds were subject to US Bank's setoff rights pursuant to Section 553 of the Bankruptcy Code. United argues that the bankruptcy court erred in finding that the funds were subject to US Bank's setoff rights.

The allowance of a setoff lies within the discretion of the bankruptcy court. *See In re Meyer Medical Physicians Group, Ltd.*, 385 F.3d 1039, 1041 (7th Cir. 2004) (*In re Meyer*). Section 553 authorizes the setoff of "mutual" debts. 11 U.S.C. § 553. "Mutuality" exists if the debts have arisen in the same right and between the same parties. *See In re Meyer*, 385 F.3d at 1041; *Martin v. Wells Fargo Bank*, 91 Cal. Rptr. 2d 653, 657 (2001). The character of the debt does not affect mutuality. *See In re Meyer*, 385 F.3d at 1041.

Here, the claims of United and the trustees against each other arise out of the same bond transactions and series of bond documents, which created the parties' respective capacities toward each other. Furthermore, as found by the bankruptcy court, United's reliance on In *re Ben Franklin Retail Store, Inc.*, 202 B.R. 955 (N.D. Ill. 1996), in an effort to defeat mutuality, is misplaced. Unlike the instant cases, *In re Ben Franklin Store, Inc.* involved a special purpose account that was held by a bank in trust for the debtor, and the debtor continued to "own" the account beneficially rather than simply being owed the money in the account. Accordingly, the bank's equitable obligation to the debtor with respect to the special account was of a different nature than the debtor's legal obligation to the bank. *See In re Ben Franklin Store, Inc.*, 202 B.R. at 958. In contrast, the construction funds of the instant cases are not held in trust for United; instead, United has a legal claim to the funds just as the banks have a legal claim against United.

Appendix B

The Category III Claims

The Category III Claims consist of funds for which United seeks reimbursement and for which United had incurred prepetition and for which a Written Request was submitted before United filed bankruptcy. The bankruptcy court held that a turnover of the funds to United was appropriate because US Bank had an obligation to turnover the funds to United as soon as a request was made. Applying the equitable maxim "that which ought to have been done is to be regarded as done, in favor of him to whom, and against him from whom, performance is due," the bankruptcy court held that the funds became United's property when it submitted the Written Request.

US Bank argues that the bankruptcy court erred in finding that United's right to reimbursement from the 2001 Construction Fund arose upon the submission of a Written Request in proper form. US Bank contends that it had the right to withhold payment to verify the accuracy of the information submitted. As demonstrated by the provisions set forth above, nothing in the Payment Agreement or Trust Agreement imposed any duty on US Bank to confirm the validity of the Written Request. Instead, per the agreements, US Bank was to rely solely on the Written Request and to make payment to United "upon receipt . . . of a Written Request [by United]." Accordingly, the bankruptcy court did not err in finding that US Bank could not exercise discretion in providing the funds following a proper Written Request.

US Bank also argues that the bankruptcy court erred in apply equitable principles.

Appendix B

The directions set forth in a trust agreement are the sole guide to the conduct of the trustee. Absent any conferred discretion, the trustee must follow the trust agreement. *See Bryson v. Bryson*, 62 Cal. App. 170, 176 (1923). The interpretation of a trust agreement and the determination of an appropriate remedy for a breach of that agreement are within the jurisdiction of equity. *See Alexander v. Hillman*, 296 U.S. 222, 239 (1935).

Pursuant to the Payment Agreement and Trust Agreement, California law governs. California has codified the common law equitable maxim that "which ought to have been done is to be regarded as done, in favor of him to whom, and against him from whom, performance is due." Cal. Civ. Code § 3529. This equitable doctrine has been utilized by courts in a variety of circumstances. *See Cortez v. Purolator Air Filtration Prod. Co.*, 96 Cal. Rptr. 2d 518 (2000) (employee had an unconditional property right in unpaid wages); *Campbell v. Bauer*, 104 Cal. App. 2d 740 (1951); *Lowe v. Los Angeles Suburban Gas Co.*, 24 Cal. App. 367 (1914).

Here, the Trust Agreement provided that US Bank was to make a payment to United "upon receipt" of a Written Request. United filed its Written Request with US Bank prior to filing bankruptcy; but US Bank has refused to provide the funds, although it had received the Written Request. United made a proper demand on US Bank for funds; US Bank's payment to United based on that Written Request may be regarded "as done" pursuant to the above equitable maxim. As such, US Bank's payment to United is regarded "as done."

Furthermore, the bankruptcy court properly found that the balance of equities favors United and not US Bank. The bankruptcy code requires United to suspend payments on the bonds and allows United the continued use of the facilities. These provisions are designed to effect an equitable distribution among all creditors of a bankruptcy estate. In addition, it is not inequitable if the bondholders receive less than the full amount of their claim since, in a less than fully solvent bankruptcy, incomplete satisfaction of claims necessarily occurs. In contrast, it would be inequitable to allow US Bank the right to a setoff merely because United filed for bankruptcy when that right did not exist at the time the payment to United was due.

US Bank further argues that the bankruptcy court erred in finding that treating the funds as if they had been transferred to United before the bankruptcy filing terminated any security interest US Bank held in the funds. However, treating the funds as having been transferred to United before it filed for bankruptcy did have the effect of terminating any security interest held by US Bank. *See* Cal. Com. Code §§ 9312(b)(3) (security interest in money perfected only by possession); 9313(d) (if perfection of security interest depends on possession, perfection continues only while secured party retains possession).

Lastly, as to these funds, the bankruptcy court correctly found that US Bank did not have a right to a setoff of the funds because, unlike the Category II Claims, the equitable transfer of the funds created ownership by United. Accordingly, mutuality no longer was present. *See In re Ben Franklin Store, Inc.*, 202 B.R. at 958.

As to the funds held by HSBC, the parties agree that the Retained Monies were analogous to the funds that were the subject of the Category I Claims. Accordingly, the agreed order entered by the bankruptcy court that granted the Retained Monies Lift Stay Motion is affirmed.

CONCLUSION

Based on the foregoing, the decision of the bankruptcy court as to the September 29, 2004 order is affirmed; and the decision of the bankruptcy court as to the October 15, 2004 order is affirmed.

Date: February 24, 2005

s/ John W. Darrah
John W. Darrah, Judge
United States District Court

APPENDIX C — ORDER OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION GRANTING IN PART AND DENYING PART CROSS-MOTIONS FOR SUMMARY JUDGMENT DATED SEPTEMBER 20, 2004

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Chapter 11

Case No. 02-B-48191
(Jointly Administered)

Adv. Pro. No. 03A04771

In re:

UAL CORPORATION, et al.

Debtors.

UNITED AIR LINES, INC., Debtor,

Plaintiff,

v.

U.S. BANK TRUST NATIONAL ASSOCIATION,

Defendant.

Appendix C

ORDER GRANTING IN PART AND DENYING IN PART CROSS-MOTIONS FOR SUMMARY JUDGMENT

This adversary proceeding having come before the court on cross-motions for summary judgment by debtor United Air Lines, Inc. ("United") and U.S. Bank National Association in its capacity as Indenture Trustee (the "Bank"), and the court having considered the motions, statements of uncontested fact, and written and oral arguments of the parties, and having issued concurrently with this Order a Memorandum of Opinion addressing the motions,

It is hereby ordered, for the reasons stated in the Memorandum of Opinion, that judgment be entered in favor of United with respect to the December 5 Draw Request described in the Memorandum of Opinion, declaring that the funds requested therein are property of United's estate in bankruptcy, and requiring that these funds be delivered to United, as debtor in possession of its estate, pursuant to 11 U.S.C. § 542(a). The Bank's motion for judgment as to this Draw Request is denied. It is further ordered that judgment be entered in favor of the Bank with respect to the December 13 Draw Request described in the Memorandum of Opinion, declaring that this Draw Request constitutes a claim of United that is offset by a claim of the Bank against United, pursuant to 11 U.S.C. § 553(a), and hence that United has no property interest on account of the requested funds, but that the Draw Request reduces the Bank's claim. It is further ordered that judgment be entered in favor of the Bank with respect to the Postpetition Costs described in the Memorandum of Opinion, declaring that United has not submitted the documentation necessary to require the Bank to recognize a payment obligation for these costs. United's motion for summary judgment as to the December 13 Draw Request and the Postpetition Costs is denied.

Appendix C

Dated: September 20, 2004

s/ Eugene R. Wedoff
Eugene R. Wedoff
United States Bankruptcy Judge

APPENDIX D — MEMORANDUM OF OPINION OF THE UNITED STATES BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION DATED AND FILED SEPTEMBER 20, 2004

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Chapter 11

Case No. 02-B-48191
(Jointly Administered)

Adv. Pro. No. 03A04771

In re:

UAL CORPORATION, et al.

Debtors.

UNITED AIR LINES, INC., Debtor,

Plaintiff,

v.

U.S. BANK TRUST NATIONAL ASSOCIATION,

Defendant.

Appendix D

MEMORANDUM OF OPINION

This adversary proceeding has come before the court on cross-motions for summary judgment brought by United Air Lines, Inc., as Chapter 11 debtor in possession ("United") and U.S. Bank National Association as Indenture Trustee ("the Bank"). United seeks a turnover, pursuant to 11 U.S.C. § 542(b), of certain construction bond funds held by the Bank under a trust agreement for the benefit of bondholders; the Bank seeks a declaration that the funds are not property of United's bankruptcy estate, or alternatively, that the Bank has a perfected security interest in the funds, that it has recoupment rights in the funds or that it has setoff rights in the funds.

As discussed below, United has three different turnover claims, all seeking reimbursement for construction expenses. The first, in the amount of $1,191,547.29, was reflected in a written request for payment that United submitted to the Bank, in the form required by the parties' agreement, prior to United's bankruptcy filing. Because the Bank had a nondiscretionary duty to honor this request "upon receipt," equitable principles, as enforced under California law, require turnover of the requested funds. United's next claim, for an additional $233,824.48, was also set out in a written request. However, since this request was submitted after the bankruptcy filing, the Bank's payment obligation is fully subject to setoff under 11 U.S.C. § 553. United's third claim, in the amount of $30,093.51, has never been submitted to the Bank in the written request required for payment, and so is also not payable. Accordingly, the motions for summary judgment of both United and the Bank will be granted in part and denied in part.

Appendix D

Jurisdiction

Federal district courts have exclusive jurisdiction over bankruptcy cases. 28 U.S.C. § 1334(a). Pursuant to 28 U.S.C. § 157(a), district courts may refer bankruptcy cases to the bankruptcy judges for their district, and, by Internal Operating Procedure 15(a), the District Court for the Northern District of Illinois has made such a reference of the pending case. When presiding over a referred case, a bankruptcy judge has jurisdiction, under 28 U.S.C. § 157(b)(1), to enter appropriate orders and judgments in core proceedings within the case. The pending motions are core proceedings under 28 U.S.C. § 157(b)(2)(A) (matters concerning the administration of the estate), (b)(2)(E) (orders to turn over property of the estate), (b)(2)(G) (motions to terminate or modify the automatic stay), (b)(2)(K) (determinations of validity, extent or priority of liens) and (b)(2)(O) (other proceedings affecting adjustment of debtor-creditor relationship). This court therefore has jurisdiction to enter a final order with respect to the motions now before it.

Statement of Facts

The facts relevant to the pending motions are undisputed.

The Agreements. U.S. Bank National Association serves as the trustee pursuant to the terms of a Trust Agreement dated April 1, 2001 (the "Trust Agreement"), between itself and the California Statewide Communities Development Authority (the "Authority"). On or about April 1, 2001, in accordance with the Trust Agreement, the Authority issued California Statewide Communities Development Authority

Appendix D

Special Facilities Revenue Bonds (United Air Lines, Inc.—Los Angeles International Airport Cargo Project) Series 2001 (the "Bonds") in the aggregate principal amount of $34,590,000. Concurrent with the execution of the Trust Agreement, the Authority and United entered into a Payment Agreement also dated April 1, 2001 (the "Payment Agreement").

The Bonds were issued to finance the costs of constructing certain improvements at the Los Angeles International Airport (the "LAX Project"). Trust Agr., Fourth Recital; Payment Agr., § 2.1(b). The Authority deposited proceeds from the sale of the Bonds into a construction fund established pursuant to the Trust Agreement (the "Construction Fund"). Trust Agr., § 3.04. All of the monies in the Construction Fund are pledged to the repayment of principal and interest on the Bonds, Trust Agr., § 5.01; Payment Agr., § 4.4, and are held in trust for the benefit of the bondholders, Trust Agr., § 3.04. However, the Construction Fund—as its name implies—was designed to reimburse United for its costs in constructing the LAX Project. *Id.* United, in turn, is obligated under the Payment Agreement to make payments of principal and interest on the Bonds. Payment Agr., § 4.2.

Requirements for disbursement of funds. In order for United to obtain disbursements from the Construction Fund, United must submit to the Bank a "Written Request of Corporation." See Trust Agr., § 3.04; Payment Agr., § 3.3. Section 3.04 of the Trust Agreement sets out the information that must be provided and the representations that must be made in a Written Request. The Trust Agreement expressly

provides that the Bank may rely on a Written Request that fulfills the requirements of § 3.04 as "sufficient evidence" that the costs stated were incurred and are properly paid out of the Construction Fund and that there are no liens on the monies to be paid. Trust Agr., § 3.04. Payment to United is to be made "upon receipt" of a Written Request. Payment Agr., § 3.3.

United's requests for payment. Prior to December 5, 2002, United had submitted numerous draw requests from the Construction Fund to the Bank, and the Bank had paid them promptly, In each of these situations, the Bank made the requested payment without taking any action to substantiate the information set out in the request. United Air Lines, Inc.'s Statement of Undisputed Facts, Exh. B, Response to Interrogatory No. 10.

On December 5, 2002, United submitted Trustee Requisition No. 11 (the "December 5 Draw Request"), requesting the Bank to disburse $1,191,547.29 from the Construction Fund as reimbursement for costs incurred by United with respect to the LAX Project. The Bank has never contended that the December 5 Draw Request fails to conform to the requirements of § 3.04 of the Trust Agreement or that it is in any way deficient. Nevertheless, the Bank has not paid it.

On December 9, 2002, four days after the December 5 Draw Request, United and its affiliate debtors filed voluntary petitions under Chapter 11 of the Bankruptcy Code, giving rise to the pending bankruptcy cases. Necessarily, then, the reimbursement sought in the December 5 Draw Request

antedates any default under the Payment Agreement triggered by United's bankruptcy filing. All of the costs included in the December 5 Draw Request were prepetition obligations of the Bank.

On December 13, 2002, United submitted Requisition No. 12 (the "December 13 Draw Request"), requesting the Bank to disburse $233,824.48 from the Construction Fund. Although this draw request was submitted after United's bankruptcy petition was filed, the costs for which it sought reimbursement were incurred prepetition. Again, while not asserting that the December 13 Draw Request is deficient, the Bank has refused to pay it.

Finally, United asserts that it has incurred an additional $30,093.51 in construction costs for the LAX Project in the time after its bankruptcy filing (the "Postpetition Costs"). United has not submitted a Written Request of the Corporation for these costs.

Payments of interest on the Bonds were due on April 1, 2003, October 1, 2003 and April 1, 2004. United has not made these payments. The failure to make these payments constitutes a default under the Trust Agreement and the Payment Agreement. Trust Agr., § 7 .01(a); Payment Agr., § 6.1(a).

Conclusions of Law

The standard for ruling on summary judgment motions is whether the party seeking judgment has demonstrated through admissible evidence that no genuine issue of material

fact exists for trial and that the movant is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c), incorporated by reference in Fed.R.Bank.Proc. 7056(c). Contract interpretation is particularly suited for disposition on summary judgment, unless the contract is ambiguous. *United States. v. 4500 Audek Model Number 5601 AM/FM Clock Radios*, 220 F.3d 539, 543 (7th Cir.2000). In this case, there are no material facts in dispute and the relevant agreements are unambiguous; therefore the matter is appropriate for summary judgment.

Each of the three claims for reimbursement asserted by United raises distinct legal issues, and so addressed separately below. Because the complexity of the issues raised by these claims is inverse to the order in which the claims were made, they are treated here in reverse chronological order.

Postpetition Costs. United's most recent claim—seeking payment of postpetition costs associated with the LAX Project—was never the subject of a Written Request of the Corporation. United argues that it is nonetheless entitled to reimbursement of these costs from the Construction Fund on the ground that it immediately obtained a property interest in the Construction Fund upon incurring construction costs, so that the submission of a Written Request was "ministerial and peripheral" and therefore not required. Complaint, ¶ 22. The Agreements do not support this argument. Under the terms of the Agreements, United must submit a Written Request before the Bank has a payment obligation of any kind. Section 3.04 of the Trust Agreement provides that "[b]efore any payment is made from the Construction Fund by the Trustee, the Corporation [United] *shall cause to be*

filed with the Trustee a Written Request for the Corporation." Trust Agr., § 3.04 (emphasis added). Similarly, § 4.1 of the Payment Agreement, addressing payment for costs of the LAX Project, states that "[t]he Corporation *shall* submit a Written Request of Corporation for disbursements from Construction Fund in accordance with § 3.04 of the Trust Agreement." Payment Agr., § 4.1 (emphasis added).

With respect to each payment sought, the Written Request must show "(1) the item number of the payment; (2) the name of the person to whom payment is due; (3) the amount to be paid and (4) the purpose for which the obligation to be paid was incurred." Trust Agr., § 3.04. The Written Request must also state that (a) each item for which reimbursement is sought has been incurred, is a proper charge and has not been previously reimbursed; and (b) there are no liens or other claims affecting the right to receive payments of the funds. *Id.*

In light of these provisions, the requirement that United submit a Written Request was a substantive condition precedent to obtaining payment from the Construction Fund and cannot be ignored by United. Since United failed to submit a Written Request with respect to the postpetition costs, the Bank has no obligation to pay United on this claim.

The December 13 Draw Request. The costs claimed in the December 13 Draw Request, though submitted after the filing of United's bankruptcy petition, were incurred prepetition. These costs represent a valid claim against the Bank (the Bank having raised no objection to its validity) but the claim is fully subject to setoff under § 553 of the

Bankruptcy Code, since the Bank has a much larger prepetition claim against United.[1]

Section 553 allows setoff if, among other things, a creditor's claim against the estate and the estate's claim against the creditor arose before the filing of the debtor's bankruptcy case. 11 U.S.C. § 553(a). United does not dispute that both claims arose prebankruptcy. Section 553(a) also requires mutuality of the parties. Mutuality exists here because United is obligated to pay the Bank as trustee and the Bank as trustee is obligated to pay United. *See In re Doctors Hosp. of Hyde Park, Inc.*, 337 F.3d 951, 955 (7th Cir.2003) ("the general rule is that mutuality is satisfied when the offsetting obligations are held by the same parties in the same capacity"). United's reliance on *In re Ben Franklin Retail Store, Inc.*, 202 B.R. 955 (Bankr.N.D.Ill.1996), in an effort to defeat the claim of mutuality, is misplaced. That case involved a debtor which had borrowed money from a bank prior to its bankruptcy filing, and which also had a special purpose account with the bank. The court found that the special purpose account was held by the bank in trust for the debtor, who continued to "own" the account beneficially rather than simply being owed the money in account. 202 B.R. at 958. Thus, unlike the present case, there was no mutality of obligation: the bank's equitable obligation to debtor with respect to the special account was of a different nature than the debtor's legal obligation to the bank. Here,

1. United's obligation to the Bank apparently exceeds $34 million, since its payments to date have covered interest accruing on the bond issue. See Trust Agr., Ex. A (Form of Bond) at A-1 (providing for interest only payments on April 1 and October 1 of each year until final maturity).

by contrast, the Construct Fund is not held in trust for United—United simply has a legal claim to it; just as the Bank has a legal claim against United. Because the competing claims of United and the Bank meet the requirements of § 553, the Bank is entitled to setoff under § 553.

Pursuant to the Bank's setoff right, United's claim here merely reduces its liability to the Bank under the Payment Agreement. The Bank's motion for a determination that United does not have a property interest in the amount claimed by the December 13 Draw Request is granted, and United motion for turnover is denied.[2]

The December 5 Draw Request. The costs associated with the December 5 Draw Request were incurred prepetition and the request itself was submitted prepetition. United argues that upon submission of the Written Request the Bank had a nondiscretionary duty to disburse the money sought. The Bank argues it had a right to withhold payment to verify the accuracy of the information submitted, and that thereafter United's bankruptcy filing constituted an Event of Default that suspended the Bank's obligation to pay United.

The Bank is mistaken. United's right to reimbursement from the Construction Fund arose upon the submission of a request in the proper form. Section 3.3(a) of the Payment Agreement sets forth the key language. It provides in relevant part as follows:

> The Corporation [United] will authorize and direct the Trustee, upon compliance with Section 3.04

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2. Given these conclusions, the Bank's arguments regarding its security interest and its right to recoupment need not be addressed.

> of the Trust Agreement, to disburse the monies in the Construction Fund to or on behalf of the Corporation only for the following purposes, subject to the provisions of Section 3.4 hereof: . . .
>
> Each of the payments referred to in this section 3.3(a) *shall be made upon receipt by the Trustee* of a Written Request of the Corporation.

Payment Agr., § 3.3(a) (emphasis added). Section 3.04 of the Trust Agreement provides that a Written Request of the Corporation that meets the requirements of that section "shall be sufficient evidence to the Trustee" that the obligations set forth in the Written Request have been incurred by United, that each item is a proper charge and that there are no liens on the monies to be disbursed. Trust Agr., § 3.04.

Neither the Trust Agreement nor the Payment Agreement imposes any duty on the Bank to confirm the validity of the submission. Rather, the agreements evidence an intent by the parties to eliminate any duty both by allowing the Bank to rely solely on the representations made in the Written Request and by specifying that prior to a default, the Bank has "such duties and only such duties as are specifically set forth in this Trust Agreement." Trust Agr., § 8.01. Similarly, prior to an Event of Default, "the duties and obligations of the Trustee . . . shall be determined solely by the express provisions of this Trust Agreement . . . ; and no covenants or obligations shall be implied into this Trust Agreement which are adverse to the Trustee . . ." *Id.*, § 8.01(a).

The Bank asserts that it nonetheless had discretion to investigate the bona fides of Written Requests, even if in

proper form. However, the Trust Agreement accords no such discretion, and exercising such a discretion would contradict the Bank's express duty of making payment payment to be made to United "upon receipt by the Trustee of a Written Request of the Corporation." Accordingly, the Bank cannot exercise discretion.

> It is a principle in the law of trusts that the directions contained within the trust agreement are the sole guide to the conduct of the trustee. It is to the trust agreement and to that only to which he must look for his orders and which orders, *in the absence of conferred discretionary powers, he must follow without question or hesitation.*

Bryson v. Bryson, 62 Cal.App. 170, 176, 216 P. 391, 393 (1923) (emphasis added), citing 4 *Pomeroy's Equity Jurisprudence* (5th ed.1941) § 1062. This is particularly true for indenture trustees. *See Elliott Associates v. J. Henry Schroder Bank & Trust Co.*, 838 F.2d 66, 71 (2d Cir.1988) (Under New York law, the duties of an indenture trustee are strictly defined and limited to the terms of the indenture); *Eldred v. Merchants National Bank of Cedar Rapids*, 468 N.W.2d 221, 223 (Iowa 1991) (trustee's duties limited to terms of indenture); *National City Bank v. Coopers & Lybrand*, 409 N.W.2d 862, 866 (Minn.Ct.App.1987) ("[A]n indenture trustee is more like a stakeholder whose duties and obligations are exclusively defined by the terms of the indenture agreement.") (quoting *Meckel v. Continental Resources Co.*, 758 F.2d 811, 816 (2d Cir.1985)).

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Interpretation of a trust agreement and the determination of an appropriate remedy for breach of that agreement are within the jurisdiction of equity. *Alexander v. Hilman*, 296 U.S. 222, 239, 56 S.Ct. 204, 210 (1935) ("All trusts, those implied as well as those expressly created, are within the jurisdiction of courts of equity."). "A court of equity will always by its decree declare the rights, interest, or estate of the [beneficiary], and will compel the trustee to do all the specific acts required of him by the terms of the trust." 1 *Pomeroy's Equity Jurisdiction*, § 158. *See Eychaner v. Gross*, 202 Ill.2d 228, 779 N.E.2d 1115, 1145 (2002) ("Courts of equity possess original and inherent power to recognize, execute, and control trusts and trust funds.") (quoting *Village of Hinsdale v. Chicago City Missionary Society*, 375 Ill. 220, 233, 30 N.E.2d 657 (1940)); *Whan v. Whan*, 542 S.W.2d 7, 11 (Mo.Ct.App.1976) (courts of equity have inherent jurisdiction over express trusts); *Dexter Horn Building Co. v. King County*, 10 Wash.2d 186, 191, 116 P.2d 507, 510 (1941) (all cases involving trusts are exclusively within the court's equity jurisdiction). Here, United's motion to compel the Bank to do the specific acts required by the terms of the Trust Agreement—namely to turn over certain funds, and to determine that United has an interest in the Construction Fund—also determines the rights and interest of the beneficiaries in the fund.

California law governs the Payment Agreement and the Trust Agreement. See Payment Agr., § 9.5; Trust Agr., § 11.08. In interpreting California law, this court must look to the decisions of California's highest court. *In the Matter of Wheaton Oaks Office Partners Limited Partnership*, 27 F.3d 1234, 1243, n. 5 (7th Cir.1994). California Civil Code

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§ 3529 codifies the common law equitable maxim that "[t]hat which ought to have been done is to be regarded as done, in favor of him to whom, and against him from whom, performance is due." Cal. Civ.Code § 3529. *Corpus Juris Secundum* explains the principle as follows:

> The broad meaning or effect of this maxim is that where an obligation rests on a person to perform an act equity will treat the person in whose favor the act should be performed as clothed with the same interest and entitled to the same rights as though the act were actually performed. It is applied only for the purpose of doing equity between the parties.
>
> The basis of the maxim is the existence of a duty and it can only be invoked against a party who has failed or refused to perform a duty imposed on him. . . .
>
> . . .
>
> Ordinarily, by application of the maxim, acts agreed to be done or directed to be done are considered as done at the time agreed or directed to be done. The principle lends its force to working out justice by fixing rights as of the time when the obligation first accrued rather than according to circumstances subsequently arising. . . .

30A C.J.S. Equity, § 121 (2003) (footnotes omitted).

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The maxim was most recently applied by the California Supreme Court in *Cortez v. Purolator Air Filtration Products Company*, 23 Cal.4th 163, 999 P.2d 706 (2000). There, an employee sued her employer under the California Labor Code and a California unfair competition law, seeking restitution and other relief in connection with the employer's failure to pay overtime wages. The California unfair competition law provided that the courts had authority to order the restitution of property acquired by unfair competition, but not to award damages. *Id.* at 173, 999 P.2d at 712. The Court concluded that unlawfully withheld wages were property of the employee when due and owing and thus could be the subject of a restitutionary order for the return of property. The Court relied upon the maxim that equity regards that which ought to have been done as done; the wages should have been paid to the employees, and thus the court treated the wages as property of the employee that the employer equitably converted and could be compelled to "return." *Id.* at 178, 999 P.2d at 716.

Several earlier California cases have also applied the maxim. In *Campbell v. Bauer*, 104 Cal.App.2d 740, 232 P.2d 590 (1951), the court held that an application to transfer a liquor license should be deemed to have been submitted by the seller of the business that used the license. *Id.* at 744, 232 P.2d at 593. "[S]igning by the transferor constitutes a compliance with the transferor's agreement to transfer. It should have been done in this case and it must therefore be regarded as done." *Id.* at 744, 232 P.2d at 593. In *Epstein v. Gradowitz*, 76 Cal.App. 29, 243 P. 877 (1925), the appellate court held that the trial court properly denied plaintiff's claim on a promissory note when the evidence supported the

affirmative defense that plaintiff agreed to cancel the note and to deliver it to defendant. "Under well-established principles, in such a situation plaintiff will be held to do the thing which he agreed to do, and for which he accepted a valuable consideration." *Id.* at 32, 243 P. at 878. And in *Lowe v. Los Angeles Suburban Gas Co.*, 24 Cal.App. 367, 378-79, 141 P. 399, 403-04 (1914), the court applied the maxim to treat principal and interest on certain bonds as immediately due and payable even though the indenture trustee refused to issue a declaration to that effect, since the trustee had the duty to do so under the trust agreement.

United made a proper demand on the Bank, which refused without justification to take the required course of action. It now seeks to avoid that obligation by reliance on the subsequent bankruptcy filing. "That which ought to have been done"—the Bank's payment of the December 5 Draw Request to United—may be regarded "as done" but for the mechanical act of transmitting the funds. This effectuates the intent of the maxim, to accord United "with the same interest and entitled to the same rights" as though the Bank had transmitted the funds.[3] *See* 30A C.J.S. Equity, § 121.

---

3. Section 3517 of the California Civil Code provides further support for this conclusion. It states, "[n]o one can take advantage of his own wrong." To permit the Trustee to assert an offset to United's claim under the December 5 Draw Request would allow the Trustee to take advantage of its own wrong in the form of an otherwise unavailable setoff. *See also Campbell v. Bauer*, 104 Cal.App.2d at 744, 232 P.2d at 593 (to permit defendants to retain liquor license securing loan following default would "permit defendants to retain the advantage of their own wrong [which] would be unconscionable.")

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The *Cortez* case requires consideration of equities on both sides of a dispute. *See Cortez*, 23 Cal.4th at 180-181; 999 P.2d at 717. The Bank argues that the balance of equities favor the Bank and not United given United's subsequent postpetition failure to make payments due under the bonds and its continuing right to use Los Angeles cargo facility built with bond funds. However, the Bankruptcy Code requires United to suspend payments on the bonds and allows continued use of the cargo facility. These statutory provisions are designed to effect an equitable distribution among all creditors of a bankruptcy estate, while maximizing the value of the estate. It was not inequitable for United to comply with them. Nor is it inequitable if, as unsecured creditors, the bondholders receive less than the full amount of their claim, since in a less than fully solvent bankruptcy, incomplete satisfaction of claims necessarily occurs. By contrast, it would be inequitable for the Bank to use the intervention of the bankruptcy filing to obtain a benefit—the right of setoff—that did not exist at the time the payment to United was due. In order to prevent the Bank from gaining an advantage over other creditors on account of United's subsequent bankruptcy filing, payment to United of the amounts sought in the December 5 Draw Request must be considered to have been made at the time of that the Written Request was submitted, prior to the bankruptcy filing.

Treating the funds as having been transferred to United before the filing of its bankruptcy case has the effect of terminating any security interest held by the Bank as trustee. *See* Cal. Com.Code §§ 9312(b)(3) (security interest in money perfected only by possession); 9313(d) (if perfection of security interest depends on possession, perfection continues

only while secured party retains possession). Nor is setoff available to the Bank. The transfer implied by California law places the Bank in the position of holding the reimbursement requested by the December 5 Draw Request in a special account, actually owned by United and not merely owed to United by the Bank. Accordingly, the mutuality required for setoff does not exist. See *In re Ben Franklin Retail Store, Inc.*, 202 B .R. 955 (Bankr.N.D.Ill.1996), discussed in connection with the December 13 Draw Request.

Section 542 of the Bankruptcy Code provides for the turnover of property of the estate. In light of the determination that California law requires that funds sufficient to pay the December 5 Draw Request be treated as having been transfered to United, funds in the requested amount, now held by the Bank, are property of the estate and are subject to turnover to United.

Conclusion

For the reasons set forth above, United's motion for turnover will be granted as to the December 5 Draw Request and denied as to United's other claims. The Bank's motion for summary judgment declaring that the monies in the Construction Fund are not property of the estate will be denied as to the December 5 Draw Request and granted as to United's other requests. The Bank's motion will also be granted so as to allow the Bank to setoff the amount sought in the December 13 Draw Request against the Bank's claim under its Payment Agreement with United.

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A separate judgment will be entered in conformity with this opinion.

Dated: September 20, 2004

s/ Eugene R. Wedoff
Eugene R. Wedoff
United States Bankruptcy Judge

APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT DENYING PETITION FOR REHEARING DATED MARCH 29, 2006

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

March 29, 2006

Before

Hon. Richard D. Cudahy, *Circuit Judge*

Hon. Daniel A. Manion, *Circuit Judge*

Hon. Diane Sykes, *Circuit Judge*

No. 05-1752, 05-1814

In re:

UNITED AIR LINES, INC.,

Debtor.

U.S. BANK NATIONAL ASSOCIATION,

Appellant, Cross-Appellee,

v.

UNITED AIR LINES, INC.,

Debtor-Appellee, Cross-Appellant.

Appendix E

ORDER

On consideration of the petition for rehearing en banc filed by appellant, and the answer thereto, no judge in active service has requested a vote on the petition for rehearing en banc, and all of the judges on the original panel have voted to deny rehearing. The petition is therefore DENIED.

FILED
AUG 11 2006
OFFICE OF THE CLERK
SUPREME COURT, U.S.

(2)

No. 05-1664

IN THE
Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION,

Petitioner,

v.

UNITED AIR LINES, INC.,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 29.6 of the Rules of this Court, Respondent United Air Lines, Inc. states that it is a wholly owned subsidiary of UAL Corporation, which is a publicly held company.

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Supreme Court Practice (8th ed. 2002) 4

INTRODUCTION

This Court should deny the petition for the simple and straightforward reason that it presents no question of federal law. This case hinges on the question whether respondent United Air Lines had a property interest in certain disputed funds when it filed for bankruptcy. (If it did, then petitioner U.S. Bank National Association is required to pay United those funds forthwith; if it did not, then U.S. Bank is entitled to set off those funds against United's debts.) As U.S. Bank acknowledged below, that question is governed by state law: "[p]roperty interests are created and defined by state law," and it thus follows that "[t]he ultimate question presented is whether, *under California law*," United possessed a property interest in the disputed funds when it filed for bankruptcy. Br. of Appellant, 7th Cir. No. 05-1752, at 10-11 (emphasis added; internal quotation omitted). Not surprisingly, both the majority and the dissent in the Seventh Circuit also recognized that this question was governed by state, not federal, law. *See* Pet. App. 9-16a, 19a, 28a.

U.S. Bank, however, now attempts to raise a federal question by suggesting that the lower courts relied on their equitable authority under *federal* law. They did not: at every stage of the proceeding below, both the courts and the litigants recognized that the issue was whether equitable principles under *California* law gave United a property interest in the disputed funds when the company filed for bankruptcy. Reasonable jurists can certainly argue about that issue, but it obviously presents no federal question for this Court's review. This Court does not sit to determine the appropriate scope of equity under California law. Accordingly, this Court should deny the petition.

COUNTERSTATEMENT OF THE CASE

A. Factual Background

In 2001, a set of agreements were established to finance the construction of a new cargo terminal at Los Angeles International Airport (LAX). Pet. App. 2a. At that time, the California Statewide Development Authority issued bonds in the amount of $34,590,000 to provide funding for the terminal. *Id.* at 3a. U.S. Bank serves as trustee for those funds under a Trust Agreement between U.S. Bank and the Authority. *Id.* at 4a. As trustee, U.S. Bank is responsible for reimbursing United for incurred construction costs "upon receipt" of a written request. *Id.* Under a contemporaneous Payment Agreement between United and the Authority, United agreed to make payments of principle and interest on the bonds. *Id.*

This system worked fine until December 2002, "when United's bankruptcy filing appeared imminent." *Id.* Before December 5, 2002, "U.S. Bank had summarily granted each request for construction funds without making any attempt to substantiate it." *Id.* at 4a-5a. On that date, "as newspapers across the country reported that United teetered on the brink of bankruptcy," United requested payment of $1.92 million (the so-called Category III funds) as reimbursement for costs incurred on the LAX project. *Id.* at 5a. U.S. Bank, however, took no action on that request, and United filed for Chapter 11 bankruptcy protection on December 9, 2002. *Id.*

Once in bankruptcy, United "ceased paying the principal and interest on the bonds," and thereby defaulted on its obligations under the 2001 agreements. *Id.* U.S. Bank thereafter refused to pay United the Category III funds, insisting that it was entitled to keep these funds as a setoff against amounts not paid by United.

B. Procedural History

United thereafter filed an adversary proceeding against U.S. Bank in the U.S. Bankruptcy Court for the Northern District of Illinois (where the underlying bankruptcy proceeding was pending), alleging that U.S. Bank was not entitled to a setoff. The bankruptcy court (Wedoff, J.), agreed. The court held that U.S. Bank had violated a non-discretionary duty under California law to pay United the Category III funds upon request, and that United thereby obtained a property right to those funds under California law at that time. Pet. App. 62-70a. The upshot of that conclusion was that U.S. Bank had no right to a setoff under California law, because under California law the payment was deemed paid when it should have been paid. *See id.*

U.S. Bank appealed, and the district court (Darrah, J.) affirmed. Again, the court recognized that "California law governs" this issue. *See id.* at 47a. As the court explained, "California has codified the common law equitable maxim that 'which ought to have been done is to be regarded as done, in favor of him to whom, and against him from whom, performance is due.'" *Id.* (quoting Cal. Civ. Code § 3529). As the court noted, "it would be inequitable to allow US Bank the right to a setoff merely because United filed for bankruptcy when that right did not exist at the time the payment to United was due." *Id.* at 48a. Because "the equitable transfer of the funds created ownership by United," no setoff was permissible under California law. *Id.*

U.S. Bank again appealed, and a divided panel of the Seventh Circuit affirmed. Once again, the majority (Cudahy, J., joined by Manion, J.) held that, "[u]nder California law," *id.* at 15a, U.S. Bank had no discretion to deny United payment upon demand, *see id.* at 9-16a, 19a. The majority further recognized that "[t]he California courts, like courts of other jurisdictions, rely on a number of equitable doctrines in different situations to provide

the relief required to redress a plaintiff's injuries when the law is unable to do so." *Id.* at 20a. The majority held that one such equitable doctrine, constructive receipt, "has the same basic thrust as the equitable maxim that the bankruptcy court relied upon," and applied here. *Id.* at 21a; *see also id.* at 22a ("The California courts are willing to apply extralegal remedies in situations where the equities demand it."). Applying that maxim, the majority concluded that United must be deemed to have received the funds before filing for bankruptcy, and hence no setoff was permissible. *Id.* at 23a. Judge Sykes dissented on this point of California law. *See id.* at 28a (emphasizing that "[s]tate law governs the determination of the nature and scope of the property interests that comprise the property of the estate in bankruptcy, as well as the setoff rights that are preserved under § 553(a) of the Bankruptcy Code," and "[i]n California (as in other states) law—not equity—provides the usual remedy for breach of contract") (citations and internal quotation omitted).

U.S. Bank sought rehearing *en banc*, but "no judge in active service ... requested a vote" on the petition, and "all of the judges on the original panel ... voted to deny rehearing." *Id.* at 73a. U.S. Bank now seeks this Court's review.

REASON FOR DENYING THE WRIT

The Petition Challenges the Seventh Circuit's Interpretation and Application of State Law.

This petition should be denied in light of the fundamental principle that this Court does "not grant certiorari to decide a question of state law." *Burks v. Lasker*, 441 U.S. 471, 486 (1979) (internal quotation and brackets omitted); *see generally* Robert L. Stern *et al.*, *Supreme Court Practice* § 4.10, at 242-43 (8th ed. 2002).

Both of the questions presented here challenge the lower courts' invocation of equitable principles to prevent

U.S. Bank from offsetting its debt to United against United's debt to U.S. Bank. *See* Pet. i. Both of the questions suggest that the lower courts purported to derive such equitable authority from some federal source. That suggestion is manifestly incorrect.

As this Court has often recognized, federal bankruptcy law operates against the backdrop of rights and obligations created by state law. *See, e.g., Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 20 (2000); *Butner v. United States*, 440 U.S. 48, 54 (1979). In particular, the Bankruptcy Code does not determine whether U.S. Bank is entitled to a setoff here; state law does. *See Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995) ("[N]o federal right of setoff is created by the Bankruptcy Code, [which] provides that, with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy."). The question here, then, is whether U.S. Bank is entitled to a setoff under California law.

The answer to that question, as the Seventh Circuit explained, turns on the principle that "[u]nder California law as preserved in [Section 553(a) of] the Bankruptcy Code, mutual *debts* arising before the commencement of a bankruptcy proceeding may be offset, subject to certain exceptions not relevant here." Pet. App. 16a (emphasis added); *see also id.* ("California law and § 553(a) require that, for setoff to apply, debts be between the same parties and that both arise before the filing of the bankruptcy petition."); *id.* at 19a ("California law expressly extends setoff rights to bankruptcy filings in situations where the creditor and the debtor share a mutual debt."); *cf.* Pet. 13 (recognizing that § 553(a) "*preserves* setoff rights") (emphasis added). That is why the crux of this dispute is whether U.S. Bank owed United a "debt" before the bankruptcy filing, or whether (as an equitable matter) United is deemed to have constructively received those funds before the filing.

That issue once again turns on California law. Thus, in deciding that United was deemed to have received the funds from U.S. Bank at the time they were due, the bankruptcy court, the district court, and the Seventh Circuit majority all turned to equitable principles under California law. *See* Pet. App. 19-23a, 47-48a, 65-70a. The dissent in the Seventh Circuit did not challenge the proposition that this issue was governed by California law, but simply argued that California would not apply equitable principles under these circumstances. *See id.* at 28a.

U.S. Bank thus misses the point by its generic challenge to the lower courts' invocation of equity in this case. Whether federal courts are entitled to invoke equity under *federal* law presents a federal issue; whether federal courts are entitled to invoke equity under *state* law does not. Here, despite U.S. Bank's best efforts at obfuscation, only state-law equitable principles are in dispute.

Accordingly, Section 105 of the Bankruptcy Code, 11 U.S.C. § 105, which gives bankruptcy courts certain equitable powers under federal law, is not implicated here—which may explain why none of the lower courts in this case relied on that provision. The extent to which there may be "dramatic disagreement throughout the case law at the circuit court, district court, and bankruptcy court levels" about the proper scope of § 105, Pet. 17, is thus immaterial, since this is not a § 105 case.

Similarly, this Court's decision in *Norwest Bank Washington v. Ahlers*, 485 U.S. 197, 207 (1988), which held that courts may not depart from the text of the Bankruptcy Code by invoking general equitable principles, has no bearing here. The lower courts in this case did not "invoke equity to avoid a result *otherwise required* by the provisions of the Bankruptcy Code." Pet. 21 (emphasis added). As noted above, the Bankruptcy Code operates against the backdrop of rights and

obligations derived from state law in the first instance, and hence the Bankruptcy Code did not "require" any result here unless and until the antecedent state-law rights and obligations were established. *See, e.g., Raleigh*, 530 U.S. at 20 ("Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code."). Because United had constructive possession of the disputed funds under California law before filing for bankruptcy, U.S. Bank was not entitled to a setoff under California law, and nothing in the Bankruptcy Code "otherwise require[s]," Pet. 21, a different result.

At the end of the day, whether the decision below is right or wrong with respect to the application of equitable principles under California law presents no question worthy of this Court's review. The courts of California sit to provide definitive answers on matters of California law; this Court does not.

CONCLUSION

For the foregoing reasons, this Court should deny the petition for writ of *certiorari*.

Respectfully submitted,

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No. 05-1664

IN THE

Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION,

Petitioner,

v.

UNITED AIR LINES, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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CORPORATE DISCLOSURE STATEMENT

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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STATUTES AND RULES

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OTHER

2 *Colliers on Bankruptcy*, (15th ed. 2006) 4, 5

ARGUMENT

United's brief in opposition asserts that "only state-law equitable principles are in dispute." Br. in Opp. 6. But that is not true. The question here is whether the federal courts have the authority, despite the limitations explicit in the Bankruptcy Code and this Court's decision in *Ahlers*, to use equitable principles of any stripe (state or federal) as a remedy to justify changing a result mandated by the provisions of the Bankruptcy Code. Even under United's reading of what happened below, in which the panel majority merely created a new state law equitable principle ("analogically" out of a federal income tax law doctrine), the panel then used that principle — not to find an independent, pre-existing state law property interest — but as a "remedy" to strip U.S. Bank of its offset rights preserved by the Bankruptcy Code. The panel majority determined that the structure created by the Bankruptcy Code to resolve the dispute between the parties was "inadequate" and instead substituted its own newly-minted "state law" equitable remedy to change the result dictated by the Code. This is precisely the kind of judicial activism that this Court reviewed, and struck down, in *Ahlers*.[1]

As carefully pointed out in the Petition, and as carefully avoided in United's response (which never quotes from or even

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1. We granted certiorari to consider the Court of Appeals' application of the absolute priority rule. . . . [W]e find no support in the Code or our previous decisions for the Court of Appeals' application of the absolute priority rule in this case. . . . [W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code. . . . In sum, because we find the decision below to be contrary to the Bankruptcy Code and this Court's previous cases, the judgment of the Court of Appeals is reversed . . . .

Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202, 206, 211 (1988). *See also id.* at 199 ("Because we find this conclusion [of the Court of Appeals] at odds with the Code and our cases, we reverse.").

refers to these dispositive words of the panel's decision), the panel majority's own words show its work; there is no need to guess (or use United's gloss) here: After concluding that U.S. Bank had breached a contractual duty to United – a duty it concluded was "mutual" and thus subject to "setoff" (App. 16a-18a) – the majority explicitly stated that "[i]n the absence of bankruptcy," it could order the result it considered appropriate: contract-based "damages." App. 19a ("we could simply order U.S. Bank to pay United now and the issue of damages would be resolved"). But the majority conceded that the reason it would not issue such an order was that, in its view, "the bankruptcy filing . . . complicates the matter," because "if we were simply to award United its damages effective today, the money would be subject to the bankruptcy filing. . . ." *Id.* The damages that could be awarded United would be subject to U.S. Bank's setoff rights afforded under the Bankruptcy Code. Accordingly, the panel majority candidly admitted, it was going to see if it could find a way around United's own federal bankruptcy filing: "The question, then, is whether California law contains a remedy that will make United whole." App. 20a.

The question was the wrong one to begin with, since no state law "remedy" can trump a outcome mandated by the Bankruptcy Code; a principal purpose of the Code is to create a structure that (while it frequently looks to state law as the foundation for property rights) displaces state law remedies. But the answer even to the incorrect question was that California law, as the panel majority found it, did not contain such a remedy. The equitable maxim the bankruptcy court had found under existing California law —"that which ought to be done shall be deemed to be done," App. 20a— appeared even to the majority to be "reaching beyond the bounds of this case to force a result." *Id.*

Undeterred, the majority then looked to Justice Holmes' opinion in *Corliss v. Bowers*, 281 U.S. 376 (1930), a decision interpreting the Revenue Act of 1924, and a forty-year-old case

from the Tax Court to find, *sua sponte*, an "apt analogy": the federal income tax "doctrine of constructive receipt." App. 21a and n.6. This it fashioned, in its own words, into an "equitable *remedy*" (not a pre-filing state law property right) to trump U.S. Bank's substantive setoff rights under pre-existing California law and the Bankruptcy Code. *Id.* 23a (emphasis added). It did so despite U.S. Bank's direct protestations, saying "U.S. Bank's characterization of recourse to equity as some rogue *remedy* is baseless. Courts consistently rely on equitable *remedies* where damages at law are insufficient." *Id.* 25a (emphasis added). But here, as the panel's own words show, the only reason the "damages at law" were "insufficient" was because "the money would be subject to the bankruptcy filing" and thus subject to offset. App. 19a.

Granting United an equitable "remedy" supported only by "analogical" reference to a federal income tax doctrine in order to get around the "insufficient" result that would otherwise be compelled by the Bankruptcy Code was patently improper,[2] conflicts with *Ahlers*, and merits this Court's review. The question presented is not, as United pretends, whether the panel's new "analogic" remedy is or is not consistent with California law; the question is whether the panel can use an equitable remedy –state or federal, newly created or respectably old – to trump the result the Code requires when a federal bankruptcy case has been filed.

United's brief in opposition also states that "Section 105 of the Bankruptcy Code, 11 U.S.C. § 105, which gives bankruptcy courts certain equitable powers under federal law, is not implicated here—which may explain why none of the

2. *See Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 24-25 (2000) ("Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides.").

lower courts in this case relied on that provision." Br. in Opp. 6. United misses the point. Section 105 is *the* source of the bankruptcy courts' equitable powers[3] and, therefore, any purported exercise of equitable powers or fashioning of equitable remedies that goes beyond the authority conferred by Section 105 is necessarily improper. A federal court cannot validly exercise an asserted equitable authority to strip a creditor of substantive rights under pre-existing state law and the Bankruptcy Code simply by declining to cite Section 105 and purporting to be acting pursuant to some other source of law.[4] In short, Section 105 is not only the source of federal courts' equitable authority in bankruptcy cases, it is also the limit of such authority.

Finally, there is no gainsaying this case represents only the latest example of a court dissatisfied with a result compelled by the terms of the Bankruptcy Code and justifying a different result based on its purported equitable powers.[5] As the leading treatise on bankruptcy law describes it:

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3. *See* 2 *Colliers on Bankruptcy*, ¶ 105.LH at 105-105 (15th ed. 2006).

4. United inaccurately states that even the dissent agreed that no federal question of equity was implicated by the panel's decision. Once again, the actual words used by the dissent dispel Unity's gloss:

> "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988); *see also United States v. Noland*, 517 U.S. 535, 539, 543 (1996). "There is no general equitable override to the Bankruptcy Code." *In re Payne*, 431 F.3d 1055, 1062-63 (7th Cir. 2006) (Easterbrook, J., dissenting). . . . Application of the [federal] taxation doctrine of constructive receipt is no more supportable than application of the California equity doctrine invoked by the lower courts.

App. 29a, 33a (Sykes, J., dissenting).

5 It is worth noting that United does not dispute that there is dramatic disagreement among the lower courts regarding the scope of (Cont'd)

> The cases and commentary reflect two general schools of thought regarding the breadth of section 105. The first recognizes that certain goals of the Bankruptcy Code are implied but not stated in the statutory language, and views section 105 as granting the bankruptcy courts authority to fill gaps left by the statutory language. The other approach is that section 105 is not a broad writ, and should be narrowly construed.

2 *Colliers on Bankruptcy*, ¶ 105.01[2] at 105-7 (15th ed. 2006); *see also id.* ¶ 105.01[1] at 105-6 ("Efforts to construe this power consistent with this purpose have split the courts.") This case squarely presents the conflict at issue, and provides a clear opportunity for the Court to address the arbitrary administration of justice in the bankruptcy courts that currently prevails based on differing interpretations of the scope of their equity powers.

This Court sits, in part, to supervise the lower federal courts when they have departed from the "accepted and usual course of judicial proceedings" as delimited by statutory provisions and this Court's decisions. Rule 10(a). That power, as it was in *Ahlers*, should again be exercised here.

CONCLUSION

The petition for a writ of certiorari should be granted.

(Cont'd)
authority to resort to equitable principles to justify results contrary to explicit provisions of the Bankruptcy Code, or that further guidance on this issue from this Court is desperately needed. *See* Br. in Opp. 6. United simply seeks to convince the Court that this issue is not actually presented in this case.

Respectfully submitted,

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